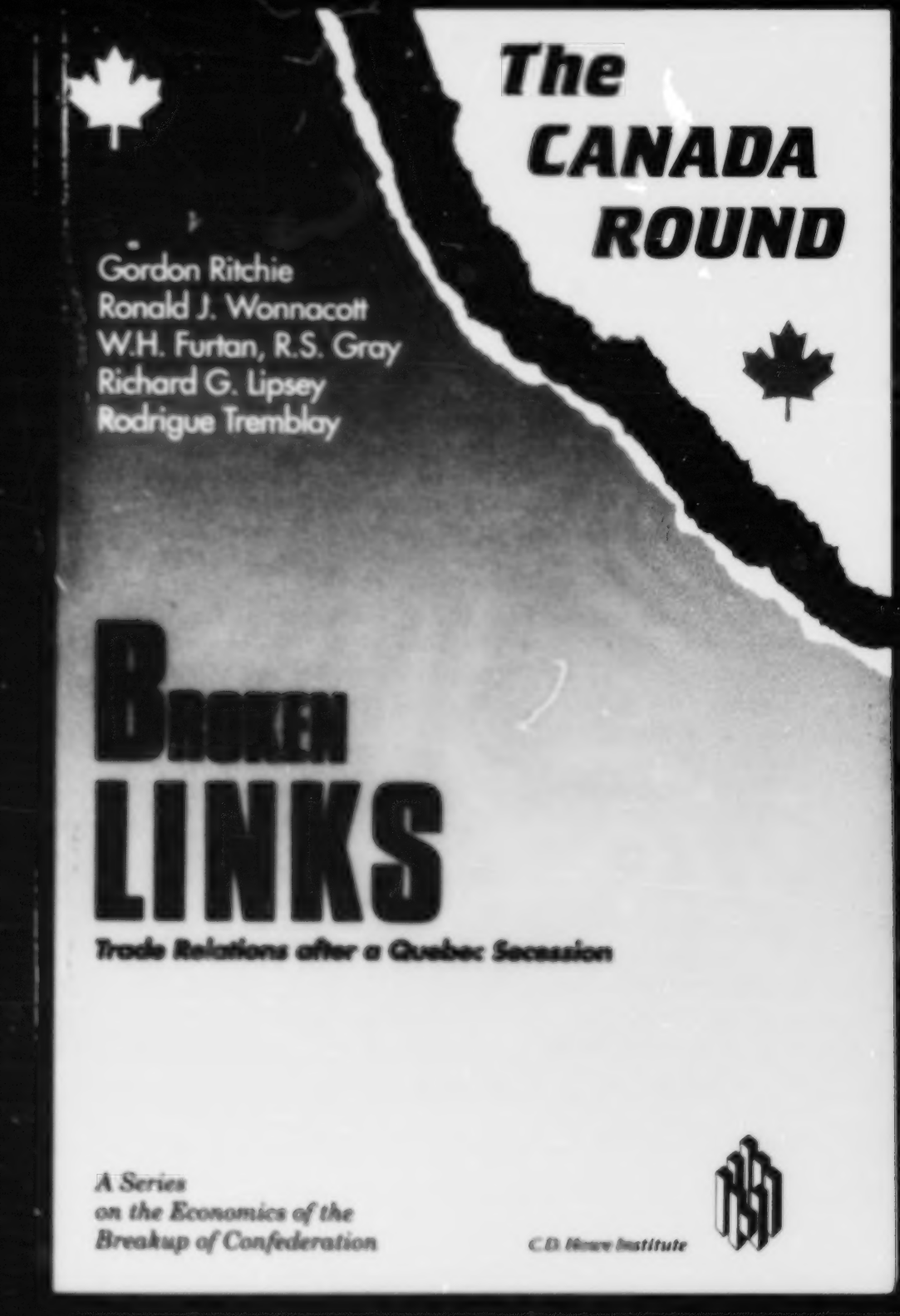


Gordon Ritchie
Ronald J. Wonnacott
W.H. Furtan, R.S. Gray
Richard G. Lipsey
Rodrigue Tremblay

# BROKEN LINKS

## *Trade Relations after a Quebec Secession*

*A Series on the Economics of the Breakup of Confederation*

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A Series on the Economics of
the Breakup of Confederation — No. 4

John McCallum, Series Editor

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# Foreword

Canada appears poised to embark on an historic political reconfiguration. It is essential that this process be undertaken with a clear and widely diffused understanding of the well-spring of Canadians' economic prosperity.

It is with that in mind that the C.D. Howe Institute presents this series of monographs entitled *The Canada Round*. The series assembles the work of many of Canada's leading economic and political analysts. The monographs are organized into two groups. The first group, called "The Economics of Constitutional Renewal", rests on the assumption of renewed federalism and is organized around economic themes. It examines the economic goals that Canadians have set for themselves, as well as the means of achieving them and the influence of alternative constitutional structures.

The second group of studies, called "Breakup", examines the economic consequences of Quebec independence for both Quebec and the rest of Canada. A unique feature of the "Breakup" studies is that they will be integrated with the research that has already been carried out by Quebec's Bélanger-Campeau Commission. Where appropriate, each of the studies in this group will include a summary of the relevant analysis by the Bélanger-Campeau Commission, contributions by experts from across Canada, as well as shorter critiques or replies. This format, we believe, will help to pierce Canada's "several solitudes" and create a pan-Canadian meeting of minds.

*The Canada Round* is not intended to alarm or frighten — the process of collective political definition in this country will turn on more than simply questions of dollars and cents. And, as these monographs will reveal, economics rarely produces an open-and-shut case as to the superiority of one possible set of rules over another. Even if it could do this, it would be unwise to assume that

economic analysis alone could change the minds of those who are already committed to a particular vision of the political future.

It is equally clear, however, that Canadians are now seeking a greater understanding of the links between the economy, the Constitution, and legal and political life. A significant reform of the Constitution will influence the economy, in some cases for the better; a rending of the Constitution under conditions of acrimony will almost certainly damage it. Thus, the purpose of the series is to help Canadians think constructively about the benefits and costs of alternative constitutional designs.

Underlying the series is a focus on the economic well-being of Canadians, now and in the future. To best insure this well-being over the short run, Canada needs calm, open negotiations in which efforts are made to understand and incorporate the aspirations of all the participants. This series of monographs is dedicated to that effort.

John McCallum, the series editor and Chairman of the Department of Economics at McGill University, organized the intellectual input. Within the C.D. Howe Institute, David Brown, Senior Policy Analyst, played a coordinating role. This fourth monograph in the series was copy edited by Barry A. Norris and desktop published by Brenda Palmer. As with all C.D. Howe Institute publications, the analysis and views presented here are the responsibility of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

Thomas E. Kierans
President and
Chief Executive Officer

# The Study in Brief

In keeping with the C.D. Howe Institute's commitment to foster an open and balanced debate, this volume in "The Canada Round" series assigns the first word and the last word to people writing from a Quebec perspective.

The study begins with a summary of the position taken by the Bélanger-Campeau Commission Secretariat[1] on the question of trade relations after a Quebec secession, and ends with a comment by Rodrigue Tremblay. In between, there are contributions by Gordon Ritchie, Ronald Wonnacott, W.H. Furtan and R.S. Gray, and Richard Lipsey.

## *The Bélanger-Campeau Secretariat's Position*

A sovereign Quebec would quickly become a member of the General Agreement on Tariffs and Trade (GATT). Quebec would also be able to negotiate entry into the Canada-U.S. Free Trade Agreement (FTA) without great difficulty, since it would not be in the interests of the United States to block such entry. While there would be no global Canada-Quebec economic union, the Secretariat assumes that the two parties would agree on common external tariffs, to maintain the current Canadian customs union and to avoid the erection of customs points between Quebec and "the Rest of Canada" (ROC). The Secretariat suggests that, after a breakup, the free movement of people, Quebec's use of the Canadian dollar, current legislation in areas such as banking and transport, and cooperative efforts in the direction of tax harmonization should all continue as before.

1 It should be noted that while the Secretariat undertook to produce several staff studies for the Commission, the Commission itself did not endorse the positions presented in those studies.

## *Gordon Ritchie: Putting Humpty Dumpty Together Again*

In a somewhat chilling contribution, Gordon Ritchie offers the perspective of a practical trade negotiator, rather than that of an academic economist (as are the other contributors to the study).

On the realities that drive trade negotiations, Ritchie notes:

> if it were easy to agree on free trade arrangements, it would not have taken us 50 years to get tariffs down to present levels.
>
> From a theoretical perspective, it might make eminently good sense for both parties simply to agree to leave everything just as it is....Indeed, rational policy suggests seizing the opportunity to reduce or eliminate some of the existing barriers and thereby actually strengthening the economic union, as proposed by the Allaire Report for the Quebec Liberal Party....In practice, trade policy has demonstrably been driven less by the overriding concept of the economic benefits of free trade and more by the dealmaking psychology of the hard-nosed trade negotiator pursuing what is seen as national self-interest.

On the nature of ROC-Quebec negotiations following Quebec separation, he says:

> Following "sovereignty", the *status quo ante* no longer governs. Instead, two sovereign countries face the need to negotiate the arrangements to govern their future relationships, including any economic association. The two parties to this negotiation inevitably will act as sovereign countries that are in pursuit of their national self-interest typically behave — no better and no worse....All bets are off, and everything is on the table.
>
> This [subsidies] would be an explosive issue. The existing panoply of assistance to Quebec industries would come under direct attack the moment Quebec assumed the responsibilities of a national government. The international rules might be applied, under which ROC would be free to apply countervailing duties to subsidized imports from Quebec that injured domestic producers.

On the view that Quebec might find it easier to negotiate with the United States than with ROC, Ritchie argues:

> Some have taken comfort from the thought that if it proved impossible to negotiate an association between Quebec and Canada, there would always be the FTA to fall back on. This "safety net" thesis is of considerable political importance. It is also dead wrong. The opposite is closer to the truth.

Ritchie goes on to discuss the fact that a sovereign Quebec would "assume the rights and obligations of a national government," the point that other parties would "bring to the table a substantial negotiating agenda," and the argument that "Quebec would bring to the table one-quarter of the Canadian market, with commensurate negotiating leverage." He discusses a long list of negotiating issues, and makes the important point that the negotiating positions of both ROC and Quebec would be strongest if they came "to the FTA renegotiation as close partners with combined clout."

Just in case readers in "English Canada" are tempted to take satisfaction in all the problems that a sovereign Quebec would face, Ritchie also notes that:

> Given the opportunity, the United States has a lengthy negotiating agenda to pursue with [English] Canada. Recalling the deeply divisive debate over the original FTA, particularly in Ontario, the consequences could be seriously disruptive.

Finally, Ritchie discusses further problems that would arise from the possible renegotiation of other agreements, notably the auto pact and defense production and development-sharing agreements.

## *Ronald J. Wonnacott: Reconstructing North American Free Trade following Quebec's Separation*

In his contribution, Ronald Wonnacott challenges the assumption that free trade would evolve between Quebec, ROC, and the United States simply because it would be in the economic interests of all three parties. He demonstrates that this would not necessarily hap-

pen — regardless of the degree of rationality of governments — by considering three cases.

First, even if governments are fully rational and pursue the national economic interest, it does not follow that Quebec would gain quick admission to the FTA. At the time of Quebec separation, the United States might have higher-priority problems to deal with or, Wonnacott argues, it might make negotiations with Quebec contingent on a prior agreement between Quebec and ROC on difficult issues in which the United States has a strong interest — such as the division of the Canadian national debt.

Second, suppose governments act rationally but, for political reasons, not in the national economic interest. Wonnacott emphasizes that the public tends to vote as producers rather than as consumers, a tendency that helps explain the slow progress in negotiating free trade agreements.

Finally, suppose governments take decisions that are not rational. In negotiating with the United States, for example, Quebec might react emotionally, especially if it were pressed to make commitments that would be perceived as an affront to its sovereignty. Such commitments might be in the area of investment and financial services, or James Bay hydro-electric development — or possibly even labor and the environment, since any negotiations with Quebec might well follow a precedent-setting free trade agreement with Mexico. Quebec would be in a weak bargaining position, Wonnacott argues, because it is not realistic to think that it would have any realistic "third option" with respect to trading partners — as Canada found out in the early 1970s.

Wonnacott then turns to the special problem of the auto industry, which is vital to Ontario's economy and, to a lesser extent, to Quebec's as well.[2] He suggests, first, that Quebec separation might mean the end of the auto pact with the United States, implying that "the future prospects of an industry that has become so important to the prosperity of Ontario and Quebec would be brought into

2 In 1989, automobiles accounted for 26.5 percent of manufacturing output in Ontario and 9.3 percent in Quebec.

question." In particular, it is not clear what would happen to plants in Ontario and Quebec — such as the General Motors facility in Ste-Thérèse. Ste-Thérèse would be in jeopardy even if the auto pact were to continue but without Quebec's participation. Wonnacott conducts a careful analysis of the interests of the Big Three U.S. auto producers, as well as organized labor. He concludes that the outcome is uncertain, but because of increasing opposition from important U.S. interests, the continuation of the auto pact in the event of Quebec separation cannot be taken for granted.

## *W.H. Furtan and R.S. Gray: Agriculture in an Independent Quebec*

In an examination of the implications of sovereignty on Quebec's agriculture sector, Huntley Furtan and Richard Gray emphasize the importance of dairy products, which accounted for 37 percent of cash receipts by Quebec farmers in 1990. Thanks to Canada's system of supply management, Quebec dairy farmers also received federal subsidies worth some $569 million in 1989, of which $150–200 million was paid by non-Quebecers. Furtan and Gray argue that dairy farmers in Quebec would lose about a third of their market if the province seceded. While Quebec benefits substantially from direct federal expenditures on agriculture, Quebec receipts are quite low in comparison with the amounts paid to farmers in Western Canada, but mainly because international grain prices have been low in recent years.

On a more speculative note, Furtan and Gray suggest that "if Quebec decided to leave, the political balance of the farm lobby in ROC could swing in the direction of free trade, thus putting some farm policies — such as supply management — in jeopardy."

## *Richard G. Lipsey: Comments on the Belanger-Campeau Commission's Papers on Trade Relations*

In his contribution, Richard Lipsey addresses some of the issues raised in background papers on trade prepared for the Belanger-

Campeau Commission. While he agrees with the Bélanger-Campeau Secretariat that Quebec's entry into the GATT would not pose serious problems — assuming Canada were to recognize Quebec sovereignty — he argues that Quebec's trade with both ROC and the United States could nevertheless be severely disrupted.

On economic relations between ROC and Quebec, Lipsey argues that a full ROC-Quebec economic union would be unlikely, and he suggests that the free movement of people might be the first casualty. Failing a full economic union, Lipsey agrees with the Bélanger-Campeau Secretariat that the maintenance of common external trade barriers would be essential — since the alternative would be to erect customs points along Highway 401 at the Quebec-Ontario border and at other border crossings. However, Lipsey is fairly pessimistic about the chances that ROC and Quebec would be able to avoid such action, despite the high costs that would be involved. Not only would the two new countries have to agree on all external tariffs and quotas; they would also have to "speak with a single voice" at all future negotiations with third countries.

On the prospects of Quebec's joining the Canada-U.S. FTA, Lipsey argues that "the common habit of personifying a country's decisionmaking process is particularly hazardous when it comes to the United States." While the optimistic arguments presented by the Bélanger-Campeau Secretariat might apply to the current U.S. administration, there is no strong reason to believe that they would apply to the more protectionist U.S. Congress. After discussing the complexity of trade negotiations and the added complications resulting from the current negotiations with Mexico on a North American free trade arrangement, Lipsey cautions:

> Given an increased representation of Democrats in the U.S. Congress, along with some further setbacks that encourage U.S. protectionist sentiments, and given a government in Ottawa that fails to appreciate the importance of the FTA, the possibility certainly exists that ROC and Quebec would lose their FTA.

It should be emphasized that Lipsey is talking about the possibility that *both* Quebec *and* ROC could end up losing the FTA.

On other issues, Lipsey offers the following conclusions:

- He foresees "a rash of [ROC versus Quebec] countervail cases based on the current subsidy practices of ROC and Quebec, and a level of antidumping actions no less than now occurs on Canada-U.S. trade."
- He rates the chances "as [no] more than 50/50 that the present protection of Quebec textile manufacturers under the Multi-Fibre Arrangement, or of Quebec farmers under provincial marketing schemes, would be continued in their present forms."
- He labels as "very civilized" the notion that the two new countries would cooperate in such areas as banking and tax harmonization, but suggests that, "over time,...separate national interests have a way of interfering with cooperation" and that "political capital can often be gained by blaming other countries for one's own problems, and pressures to favor one's own producers and consumers build up."

Lipsey argues that in "the harsh world of...growing pressures to manage trade," Canada's diminished clout in trade diplomacy that would result from Quebec separation "should not be treated lightly."

In concluding, Lipsey states:

> The number of issues raised here, any one of which could have serious consequences, must be a cause for concern. Those politicians who say to the public, "the political separation of Quebec from the rest of Canada is a low-risk operation with few potential downside consequences," are guilty of seriously misinterpreting a complex and highly uncertain situation.

## *Rodrigue Tremblay: Constitutional Political Economy and Trade Policies between Quebec and Canada*

> Nobody of influence in Quebec is talking the 19th-century language of establishing customs points and independent currencies. The 21st-century fact of North American economic integration is widely accepted, and parochial politicians who would

> attempt to stir emotions against economic integration with ROC would have little success....
>
> Threatened political empires always resort to tactics of intimidation to preserve their hegemony; the only difference is that some go further than others.

In the final paper, Rodrigue Tremblay emphasizes the importance of distinguishing between statements made *before* and *after* a change in Quebec's political status. It is natural, he argues, for federalists to advance doomsday scenarios in an attempt to reduce the likelihood of Quebec separation. After the event, however,

> it would be most foolish for the Canadian and Quebec governments...to behave in such a manner as to require a reopening of the FTA. Such a move would jeopardize a large and strategic part of Ontario's industrial structure and would also hurt Quebec's economy.

Moreover, Tremblay argues, it is obviously

> in the fundamental industrial interests of both ROC and Quebec that a *common market relationship* continue to operate....Doomsday scenarios can be intellectually appealing, but economic realities would undoubtedly exert their basic influences in framing real governmental choices.

A dismantling of the rules of the present common market would imply the erection of customs barriers, the application of rules of origin on ROC-Quebec trade, the loss by ROC and Quebec companies of their right of establishment and national treatment status, and the replacement of competition laws with countervailing and anti-dumping laws. A splitting up of the Canadian monetary union would imply the dismantling of the present interregional banking system and the existing integration of Canadian and Quebec capital markets — in short, "shooting oneself in the foot." If this can be avoided, however, ordinary citizens and large corporations alike would benefit. Tremblay suggests that

> the only possible net losers from a political rearrangement between Quebec and ROC would be professional politicians and

> bureaucrats in Ottawa, since a smaller central government...would reduce their importance. This is why end-of-the-world scenarios can be expected to originate from these quarters.

Tremblay also comments on a number of more specific points raised by the other contributors. He argues that Canada might remain a member of the Group-of-Seven large industrial countries if the Canadian economic union were maintained. He also argues that trade and agriculture policy would have to be considered as a whole. A total and comprehensive approach would be preferable to a policy of picking on clothing, dairy products, and other specific industries in which Quebec is particularly vulnerable.

## *Conclusion*

The contributors, then, are in pretty solid agreement on the *economically desirable* response to the threat of Quebec separation: maintain the status quo in terms of trading relations and, if anything, make the Canadian economic union stronger than it is today. Where they differ sharply is in their assessment of the likelihood that this economically desirable outcome would actually come to pass.

John McCallum
Series Editor

# *The View from Bélanger-Campeau:* Access to External Markets under Quebec Sovereignty

a summary by
John McCallum

This is a brief summary of Ivan Bernier, "Le maintien de l'accès aux marchés extérieurs: certaines questions juridiques soulevées dans l'hypothèse de la souveraineté du Québec"; and Secretariat of the Commission on the Political and Constitutional Future of Quebec [Bélanger-Campeau Commission], "L'accès du Québec aux marchés extérieurs et à l'espace économique canadien," both in Bélanger-Campeau Commission, *Éléments d'analyse économique pertinents à la révision du statut politique et constitutionnel du Québec* [Background Papers], vol. 1 (Quebec, 1991). It should be noted that the Commission itself did not endorse the contents of these studies.

## *Four Questions*

Ivan Bernier asks and answers four questions from a legal perspective:

1. *Assuming Quebec sovereignty, what are the conditions for entry into the General Agreement on Tariffs and Trade (GATT)?*

There are two possibilities: entry by negotiation (Article XXXIII) and entry by succession (Article XXVI). The first route can be long and arduous, and in the meantime the country is not a member of the GATT — although there are various degrees of membership, some

of which may occur relatively quickly. Entry by succession under Article XXVI is the preferred route and is relatively automatic when part of a member country becomes independent. It seems that the successor state is tied to conditions previously accepted by the predecessor state, although this is not entirely clear. If Canada did not accept Quebec sovereignty, then the situation regarding entry into the GATT would become unclear.

2. *Assuming Quebec sovereignty, to what extent could Quebec count on the GATT to assure continuing access to Canadian market, especially for agricultural products?*

On tariffs, Quebec would have "most-favored-nation" status and would pay the appropriate Canadian tariffs — unless it were to negotiate a customs union with Canada. The situation regarding quotas and nontariff barriers is more complex and less certain. Quebec's position on dairy product marketing boards might be protected. Whether or not Quebec became sovereign, however, rules governing subsidies likely would tighten up gradually and Quebec (and Canada) would have to respect such rules.

3. *Assuming Quebec sovereignty, what would happen to the Canada-U.S. Free Trade Agreement (FTA)?*

Since the 1978 Vienna Convention on the succession of states, the continuity of previous treaties has been favored as a matter of principle. However, since Quebec's entry into the FTA would change the nature of the agreement "radically" — for example, a shift from two partners to three — this entry would not be automatic, but would have to be negotiated. Also, the renegotiated three-party agreement would have to be submitted to the GATT for approval.

4. *How would the United States react to Quebec's secession?*

For economic, political, and strategic reasons, the United States would want to preserve existing agreements, and it would not

impose new conditions on Quebec's entry in the FTA. Politically, the United States would want to avoid instability and conflict and would favor the maintenance of the Canadian economic union. If the United States were to refuse to negotiate with a sovereign Quebec, this would force Quebec to look elsewhere for trading partners — something that would not be in the strategic interest of the United States. From an economic standpoint, the United States already benefits from the FTA because of its access to Quebec hydro-electric power and in the areas of services and investment. It is unlikely to want to give up these advantages, especially at a time when it is negotiating free trade with Mexico and planning similar negotiations with other Latin American countries. The United States might be tempted to demand that Quebec make concessions in certain areas — such as supply-management systems and trade in alcoholic drinks — but it would also have to renegotiate these things with Canada, and to enter into a partial renegotiation of the FTA would be dangerous.

## *Relations with the Rest of Canada*

The Bélanger-Campeau Secretariat paper begins by summarizing Quebec's external economic relations. In 1984, which is the latest year for which data are available, 48 percent of Quebec manufacturing production was sold outside the province. Of this amount, 60 percent went to the rest of Canada, 32 percent went to the United States, and the remaining 8 percent went to other foreign countries. Of Quebec's exports, 35 percent went to Ontario, while 20 percent of Ontario's exports went to Quebec. Over the 1974–84 period, the share of Quebec's production going to the rest of Canada remained quite stable, while the share going to foreign countries increased from 9 percent to 13 percent.

In the event of Quebec sovereignty, there would be no global agreement on economic union, although there might be bilateral sector-specific agreements. In the area of trade policy, the objective would be to adopt an agreement that preserved the free movement of trade between Canada and Quebec, which is estimated at more

than $100 billion in 1991. It would also be necessary to have common external tariffs in order to maintain the customs union and avoid the erection of customs points.

Would Canada maintain protection in the case of industries concentrated in Quebec — for example, clothing, textiles, and dairy products? Both parties would have an interest in maintaining common external tariffs. Moreover, other provinces also benefit from protection in these areas. In textiles and clothing, which are the most protected industries, Quebec accounts for 48 percent and 61 percent, respectively, of Canadian production. But Ontario accounts for 44 percent of Canadian textile production and 27 percent of clothing production. More generally, in 1987, 30 percent of Quebec's manufacturing production — compared with 17 percent for Ontario and 29 percent for all other provinces — was in industries having a most-favored-nation tariff of 10 percent or more. Consequently, a substantial tariff reduction would also affect other provinces.

On milk, Quebec farmers currently account for 48 percent of total Canadian production. It would be difficult, given GATT rules, for Canada to change its quota system at the expense of Quebec producers. The rules would allow a total elimination of tariffs on milk, but this would also hurt milk producers in the rest of Canada. Quebec's bargaining power on these and other commercial policy matters would be greater than Canada's bargaining power relative to the United States. In any event, changes in GATT rules are likely to make the issue of protection of clothing and textiles less important over time.

On other aspects of the Canada-Quebec economic relationship, Quebec should continue to use the Canadian dollar — with or without Canada's agreement; the free movement of people and portability of social programs and pensions should continue; current federal legislation in areas including banking, competition policy, patents, bankruptcy law, and transport should be maintained; and policies aimed at increased harmonization of taxes and pension plans should also be continued.

# *Putting Humpty Dumpty Together Again:*
## *Free Trade, the Breakup Scenario*

Gordon Ritchie

What would be the impact of Quebec sovereignty on trade relationships with the rest of Canada and North America? The answer depends on the nature of the new arrangements to be negotiated. This essay sketches some implications from a practical negotiating perspective.

## The Conceptual Framework

The economic theory on the benefits of freer trade is compelling and robust. Overall, the result of freeing trade is to increase productivity through restructuring production to serve broader markets; to hold down prices through increased import competition; to increase real incomes; thereby to increase demand for products and services; thus stimulating economic growth and employment. The specialization of production and distribution through freer trade contributes to higher living standards for the participants. The removal of trade barriers increases these benefits. The erection of barriers imposes corresponding costs.

### *The Canadian Experience*

This theory is supported by the practical experience of a century of evolution of the Canadian national economy from a scattered group of colonies to a major industrial power. It is corroborated by the

international trade liberalization of the past 45 years, which has seen Canadian exports increase more than 50-fold.

Over the past 125 years, Confederation has built up the Canadian common market to the point where it today constitutes the seventh-largest market in the developed world. In principle, people, goods and services, and capital are free to move anywhere within Canada. Within a market of this size — with a gross national product of some $700 billion — most of the benefits of specialization can be achieved in most industries.

In practice, there are shortcomings: professional and trade certifications can limit personal mobility; there are important obstacles to interprovincial trade, particularly in supply-managed agricultural commodities and provincial government purchases of goods and services; and there are discriminatory elements in provincial financial regulatory regimes. These failings reduce the benefits Canadians enjoy from the workings of the Canadian common market. The Canadian Manufacturers' Association estimates that these interprovincial barriers impinge on perhaps 10 percent of gross domestic production, at a cost of some $6 billion a year.

The fundamental fact remains that, for most activities, Canada does represent a true single market. Indeed, it clearly surpasses the integration envisaged by the much-touted "single market" proposals the European Community aims to have in place by 1993. The complete absence of customs and immigration formalities at the provincial frontiers is only the most obvious symbol of the difference.

As a consequence, nearly half the goods manufactured in a province are consumed in that province, according to studies prepared for the Bélanger-Campeau Commission. Typically, half of the balance of these goods is shipped to and consumed in other Canadian provinces. Thus, about three-quarters of total Canadian manufacturing production benefits from the economies of scale that flow from the single Canadian market.

The remaining quarter of Canada's manufacturing production is exported to other countries. The pattern differs significantly from province to province: Quebec manufacturers are relatively more

dependent on trade with other regions in Canada and benefit relatively less from foreign trade, although these patterns are changing rapidly. Overall, more than three-quarters of Canada's external trade is with the United States. Most of this trade is free of tariffs today, thanks to a series of multilateral agreements (for example, the General Agreement on Tariffs and Trade — GATT) and bilateral agreements (for example, the auto pact). With the implementation of the Canada-U.S. Free Trade Agreement (FTA), virtually all of this trade is scheduled to be free by the beginning of 1998.

For primary resource industries, the proportion consumed within Canada is somewhat lower, as a greater share is dependent on export markets. For tertiary service industries, the proportion is much higher, as most services produced in Canada are consumed here. All of these sectors must benefit from increased specialization within the Canadian federation. While researchers may argue over the precise value of this benefit, it is agreed that it must be substantial.

This is the starting point of the analysis. The living standards of all Canadians are significantly enhanced by the ability to serve freely a single national market. They are further enhanced by Canadians' access to foreign markets, principally in the United States. In the event of a breakup of the Canadian federation, what would be the consequences?

## Sovereignty-Association

The most important issue is the regime that would have to be negotiated to govern trade between Quebec and the other provinces. Quebec constitutes a major market for producers in the rest of Canada. For Quebec producers, the major external market is Canada, particularly Ontario. These trade flows must be the principal sources of economic benefit from the single market existing under federation and, therefore, of the principal costs associated with a breakup that would disrupt them.

In the event of breakup, a sovereign Quebec would confront a sovereign "Rest of Canada" (ROC) in negotiations aimed at establishing the basis for continuing economic relationships. From a

theoretical perspective, it might make eminently good sense for both parties simply to agree to leave everything just as it is. This is, in essence, the proposition advanced over the past 15 years by the proponents of "sovereignty-association". As laid out by the Parti Québécois government in 1979, this would entail: (i) Quebec's separating from Canada but, simultaneously, putting in place a new regime of "association" between the two partners; and (ii) a monetary and customs union, to be administered on a joint basis of "parity". By these means, both parties could continue to enjoy most, if not all, of the benefits of the existing federation. No one would gain from the erection of new barriers. Indeed, rational policy suggests seizing the opportunity to reduce or eliminate some of the existing barriers and thereby actually strengthening the economic union, as proposed by the Allaire Report for the Quebec Liberal Party.

The logic may be impeccable. Its relevance is questionable. If sovereign nations reasoned in this manner, there would presumably be no tariffs or other trade barriers in place at all. Instead, it has taken nearly half a century to lower trade barriers to their present levels from the high water mark of the 1930s. Attempts to reduce barriers further — let alone to eliminate them — in the current, Uruguay Round of GATT negotiations are locked in stalemate. In practice, trade policy has demonstrably been driven less by the overriding concept of the economic benefits of free trade and more by the dealmaking psychology of the hard-nosed trade negotiator pursuing what is seen as national self-interest.

What does this suggest for the prospects for "sovereignty-association?" The end point will depend critically upon the path followed. In an ideal world, any separation would be the result of careful, cool-headed, and amicable negotiation. No step to separate would be taken until full agreement had been reached on the successor regime. Both parties would be motivated by a profound commitment to retain the closest possible association to their mutual benefit. Critics would observe that this process is highly unlikely, even fantastic. After all, if such a mood prevailed, there would be little reason to separate in the first place.

A very different scenario is possible. The negotiations may be triggered by Quebecers' determination that the existing relationship is intolerable, leading to a unilateral declaration of independence. The rest of the country may then be put in the position of responding, under duress and in acute disarray, to a situation of intense political uncertainty. Under these circumstances, negotiations, if they are possible at all, may be characterized by acrimony and bitterness in the extreme.

In either case — or, more probably, in the case of anything in between — the fundamental point is this: following "sovereignty", the *status quo ante* no longer governs. Instead, two sovereign countries face the need to negotiate the arrangements to govern their future relationships, including any economic association. The two parties to this negotiation inevitably will act as sovereign countries that are in pursuit of their national self-interest typically behave — no better and no worse. They will not act as fellow citizens of a united country, inheritors of the tradeoffs and compromises worked out through the national government over 125 years. All bets are off, and everything is on the table.

Furthermore, it is not generally understood to what extent the international responsibilities of a national government go beyond those that are borne by subnational governments. On many issues, the Canadian government and the national governments of other federal states have resisted any attempts to impose national obligations on subnational (state or provincial) governments. For example, the GATT code on government procurement does not apply to any provinces or their agencies. By the same token, the FTA obligations on investment do not specifically apply to the provinces. In declaring its sovereignty, Quebec would also be declaring its willingness to assume this new set of national obligations.

## *An FTA or a Customs Union?*

The most important issue will be the basic structure of the arrangement. Is the objective a free trade area or a customs union? The

difference is fundamental. In a free trade area, national frontiers are maintained, and goods crossing the internal frontier must meet stringent origin requirements. In a customs union, the trade border is *de facto* at the outer frontier, where a common external tariff is applied, but some formalities are required at the internal borders. Within the federal system, of course, there are no restrictions at the internal borders themselves.

The crux of the issue may be captured by a look down Highway 401 at the Quebec-Ontario border on a weekday afternoon. Any impediment to that ceaseless flow of traffic would be very costly: while a customs union would significantly slow the flow of activity — depending on the extent of border formalities required — a free trade arrangement would bring the traffic to a virtual standstill.

Clearly, any negotiated arrangement among sovereign parties will involve the loss of some of the benefits of the existing federal system with its single national market. The choices come down to these:

- A *free trade agreement* would maintain each party's sovereign right to run its own independent external trade policy, but at significantly greater economic cost. Border posts would be required to determine what goods and services qualified under closely defined rules of origin. Nonqualifying goods and services would be subject to the full, "most-favored-nation" tariff and other restrictions.
- A *customs union* would require agreement between Quebec and its much larger ROC partner on a common external trade policy, including a common external tariff, common quota restrictions for agriculture, and other items. If agreement could be reached on these matters, the overall costs would be somewhat reduced and border formalities could be kept to a minimum.

Unfortunately, there is no assurance that a customs union could be negotiated, particularly if the atmosphere is less than completely friendly.

## *The Negotiating Agenda*

These are among the chapters to be negotiated in any such customs union between ROC and Quebec:

*Tariffs*. A customs union requires a common external tariff. If there is no prior agreement to leave the current tariff untouched, this could prove to be a very difficult negotiation. There would be strong pressures to set certain tariffs at levels different from the current Canadian tariff. To take one obvious example, ROC consumers may be unwilling to continue to pay the very high effective tariffs (often exceeding 50 percent) on imported clothing, footwear, and furniture in order to profit firms located principally in Quebec.

*Quotas*. The main issue here will be the import quotas to shelter the agricultural supply-management programs for dairy and poultry products. The existing system guarantees Quebec milk producers nearly 50 percent of the Canadian market at prices twice that of the competing imports, which are excluded from the market. The head of the Union des producteurs agricoles, a committed supporter of sovereignty, has stipulated that this regime must continue under any future association. This is not likely to be acceptable to ROC.

*Government Purchasing*. The federal government has largely turned a blind eye to the fact that most provinces favor their own producers to some extent. Repeated attempts to clean up this system have met with failure. In any negotiation, there would be strong pressures to eliminate discrimination in purchases by national government departments and agencies, including such bodies as Hydro-Québec (but not Ontario Hydro, which is the agency of a subnational, provincial government).

*Services*. In general, individuals and firms have the right to provide their services in any province, by establishing a commercial presence in that province or by operating from a base in another province.

There are important exceptions, notably in the financial and communications sectors and in certain professions. These would be very sensitive issues between ROC and Quebec. The negotiations would determine what discriminatory restrictions, if any, were to be permitted at the national level.

***Investment***. Currently, the screening of most investments is at the federal level but with the close involvement of the affected province. Some provinces also have restrictions on, for example, the sale of land, especially farm or shore properties, to nonresidents of the province. In the past, provincial governments have also intervened when the acquisition of a major company was threatened, as in the case of British Columbia's blocking a major acquisition by Montreal-based Canadian Pacific. Agreement would have to be reached on what discriminatory restrictions, if any, were to be permitted at the national level. It is unlikely that ROC would agree to any explicit restrictions on provincial measures.

***Subsidies***. Today, there are no domestic restrictions on provincial assistance to industry. This contrasts with the international situation, where countervailing duties may be applied when subsidized imports threaten to injure domestic production. This would be an explosive issue. The existing panoply of assistance to Quebec industries would come under direct attack the moment Quebec assumed the responsibilities of a national government. The international rules might be applied, under which ROC would be free to apply countervailing duties to subsidized imports from Quebec that injured domestic producers. Alternatively, agreement might be reached on a set of rules defining permitted and illegal subsidies at the national level, possibly giving some leeway for genuine regional development assistance — for example, in Quebec, the Gaspé; in the rest of Canada, the Atlantic provinces and Manitoba.

***Institutional Provisions***. An entire new set of institutions would have to be established, through negotiations, to manage the new

arrangements and to resolve the inevitable disputes. This could well include a special tribunal to serve as the final arbiter of matters arising under the arrangement.

This brief illustrative list provides some insight into the complexity of these negotiations. With the best of goodwill, many of these issues, from milk quotas to industrial subsidies, will be extremely difficult to resolve. Lacking that will, it is by no means a foregone conclusion that agreement could be reached.

## *Economic Implications*

What are the economic implications? First, it is clear that any agreement will involve significant costs relative to the existing system. Even with its many imperfections, the federation does permit realization of most of the economies of scale and specialization achievable from the seventh-largest industrial economy for most sectors of economic activity. As a general rule, the fewer the changes to the present system, the smaller the cost. Some costs would be inevitable as, for example, a new system to settle disputes would have to replace the existing legal system. In other areas, there would be a serious effort to cut costs in one jurisdiction at the expense of the other — for example, ROC's refusing to carry the burden of Quebec's inefficient dairy production.

Running down the list, it is clear that Quebecers would be the biggest losers from a tough negotiation — Quebec has made more aggressive use of government purchasing or industrial subsidies than have Ontario or the western provinces. Quebec enjoys a favorable balance of trade with ROC (some $3.3 billion on trade of $15 billion in 1984, according to work for the Bélanger-Campeau Commission). And, as the smaller partner, Quebec would have less bargaining leverage than its ROC associate. There would, however, be significant costs to be borne by ROC producers and consumers from any agreement that made it more difficult to move across the

frontier. Ontario, in particular, would be affected by any barriers to trade with its major trading partner.

Indeed, the biggest incentive for accommodation to prevail in these negotiations would be the disastrous consequences of a breakdown. It is simply unthinkable that formal barriers would be erected at the border, bringing the natural flow of cross-border economic activity to a grinding halt. Unfortunately, this result cannot be ruled out: a serious miscalculation on either side, leading to overplaying the cards, could lead all too easily to an irreversible breakdown.

## North American Free Trade

Some have taken comfort from the thought that if it proved impossible to negotiate an association between Quebec and Canada, there would always be the FTA to fall back on. This "safety net" thesis is of considerable political importance. It is also dead wrong. The opposite is closer to the truth.

### *The Legal Framework*

In the event of Quebec independence, there is simply no basis for assuming that the FTA would automatically continue to apply. The FTA is an agreement between the national governments of two sovereign states, the United States and Canada, as defined by the territories to which their respective customs laws apply. The breakup of Canada would invalidate the agreement, certainly with respect to Quebec and very possibly, in practice, with respect to the rest of Canada.

Much research was undertaken for the Bélanger-Campeau Commission on the rights and obligations of successor states, drawing insight from the Vienna Convention and other international models. The conclusion is inescapable: Quebec, in separating from Canada, would lose its benefits under the FTA and would be required to negotiate for re-admission.

Some have suggested that this is a minor detail, that it would be in the interests of all parties to agree to continue exactly as before. Indeed, it would be very much in the interests of all parties to reach some form of special economic relationship for the same reasons that led Canada and the United States to negotiate the FTA and to negotiate its extension to Mexico. That said, it is not at all a foregone conclusion that these negotiations would be successful. It is certain that any new arrangement will differ significantly from the existing agreement. The key considerations include the following:

- the FTA was negotiated on behalf of a united Canada, which encompassed Quebec as a subnational government;
- in any renegotiation, Quebec would assume the rights and responsibilities of a national government;
- the other parties to the agreement (the United States and Canada) would bring to the table a substantial negotiating agenda; and
- Quebec would bring to the table one-quarter of the Canadian market, with commensurate negotiating leverage.

The most critical question in assessing the impact of sovereignty on the FTA is, again, the association that is negotiated between Quebec and ROC. In the most favorable case, such an association virtually restores the *status quo ante* and puts the new arrangement in place at the moment of separation. In this case, ROC and Quebec would come to the FTA renegotiation as close partners with combined clout. Any departure from this outcome would weaken Quebec's bargaining position. Unfortunately, as noted above, it is probable that the best that could be achieved would be some form of customs union.

## *Negotiating Issues: Quebec*

Even under the most favorable circumstances, Quebec would face difficult challenges in its quest for full-party status to the FTA. Among the issues would be the following:

***National Treatment***. The FTA requires the national governments to treat imported goods no less favorably than their own. As a national party to the new agreement, Quebec would be required to meet this standard, which would, among other things, require it to dismantle existing barriers against the goods and services from other Canadian provinces.

***Government Procurement***. As a national government, Quebec would have to be prepared to open up its purchasing by government departments. The United States (and ROC) would probably also demand that Hydro-Québec cease its aggressive promotion of local industry at the expense of external competitors.

***Financial Services***. The FTA provisions apply only at the national level. With the removal of the Canadian umbrella, the United States would target the array of measures considered to discriminate in favor of Quebec financial institutions. The main targets would include the Caisses populaires, which enjoy special privileges not open to other firms — for example, in the raising of funds and the provision of services. Canada would also insist on "national treatment" of its firms operating in Quebec.

***Industrial Subsidies***. This could be one of the most difficult areas of negotiation. The United States would return to the attack on "unfair trade practices", focusing on government financial assistance to industry. This would be particularly threatening for Quebec, which, among industrial centers in North America, makes heaviest use of these instruments. Particularly vulnerable would be the use of low-cost electricity as a tool to attract large-scale manufacturers.

***Import Quotas***. The existing supply-management regimes would be targeted for liberalization or termination. In the case of poultry, ROC and Quebec would probably make common cause in defending the existing regime. In the case of the dairy industry, Quebec would be isolated. At most, Quebec would be able to maintain quotas, at more

generous levels, to protect its own market but would lose its preferential access to the Canadian market.

***Specific Irritants.*** It would be naive in the extreme to expect the United States to forego the opportunity to pursue any number of other issues in these negotiations. The list would range from such specific issues as co-production of films, to fundamental questions defining the role of the state (for example, the Caisse de dépôt et placement du Québec) in the market economy, to issues of U.S. national security (for example, defense arrangements). As the tiresome litany goes, "Everything will be on the table."

In addition, there would be an array of technical issues to address. The admission of Quebec would also raise a number of institutional issues to the extent that it would trilateralize the institutions of the FTA.

## *Negotiating Issues: Canada*

It is widely assumed that ROC would remain party to the FTA, regardless of Quebec's situation. This is highly questionable both in law and, more importantly, in practice. Again, much depends on the association established between Quebec and ROC.

If this association falls significantly short of the present arrangement — that is, if there has been a failure to preserve the existing Canadian common market — all bets are off. Under the traditional doctrine of *rebus sic stantibus*, such an international treaty may be rendered inapplicable through a fundamental change in circumstances. The breakup of the Canadian federation, with the separation of Quebec, would surely constitute such a circumstance. In this case, the United States would be fully within its rights to demand a substantial renegotiation of the terms of the agreement. Indeed, even if ROC and Quebec were able to conclude a close economic association, the United States would be free to invoke the six-month termi-

nation clause under the FTA, giving the breakup as its political justification.

It would therefore be a serious mistake to conclude that ROC would continue automatically to enjoy the benefits of the FTA. Some form of renegotiation could well be required. In this case, the negotiating issues might include the following:

***Countervailing Duties***. Canada has made very effective use of the binding dispute settlement provisions of the FTA to curb U.S. abuse of countervailing duties, most recently in the case of pork. Under pressure from Congress, the United States would almost certainly seek to weaken this regime as part of any renegotiation.

***Cultural Industries***. It remains very much a U.S. negotiating priority to dismantle the protection of Canada's publishing, broadcasting, film, video, and audio recording industries.

***Automotive***. This is another fixture in the U.S. negotiating agenda. The United States is determined: (i) to keep the Asian transplants (Honda, Toyota, and Suzuki in Ontario, Hyundai in Quebec) from shipping into the U.S. market; and (ii) to nullify the impact of the safeguards in the auto pact.

***Forest Industries***. Among the U.S. objectives would be: (i) to force resolution of the continuing dispute over plywood standards, on U.S. terms; and (ii) to maintain the crippling restrictions embodied in the Memorandum of Understanding on Softwood Lumber.

***Alcoholic Beverages***. The United States is highly dissatisfied with what it considers continuing discrimination against U.S. wines, principally in Ontario. Trade in beer, which was excluded from the FTA, has now also become a highly contentious issue.

The conclusion is simply this: given the opportunity, the United States has a lengthy negotiating agenda to pursue with Canada.

Recalling the deeply divisive debate over the original FTA, particularly in Ontario, the consequences could be seriously disruptive.

## *Other Canada-U.S. Agreements*

The FTA is only one of the important bilateral agreements from which Canada, including Quebec, currently benefits in its dealings with the United States. Others include the defense production and development sharing agreements and the auto pact.

The former is aimed at permitting Canadian industries, particularly in high-technology fields, to supply U.S. as well as the much smaller Canadian defense requirements. The objective is to achieve something approaching balance in the two-way trade, although in recent years the results have fallen short. This set of agreements has been vital to the development of a number of industries — particularly in the aerospace industry, which has its most important center, as a result of national policies, in the Montreal region.

In the event of separation, these agreements would have to be renegotiated. Under the most favorable scenario, ROC and Quebec would retain a common defense effort and would attempt to maintain something close to the present arrangements with the United States. This would be difficult. It is far from clear that: (i) ROC would be prepared to agree to "parity" in the co-management of the national defense industrial base; (ii) ROC would be prepared to continue to subsidize the development of Quebec aerospace and shipbuilding industries at the considerable expense of the rest of the country; and (iii) the United States would be prepared to continue to extend the benefits of the sharing arrangements without, as a minimum, firm understandings regarding common continental defense. Failure to maintain the existing arrangements would obviously be disastrous for the aerospace and shipbuilding industries in Quebec.

The other key agreement is the auto pact. Without this agreement, it is doubtful that the Canadian automotive assembly industry would have achieved anything close to its present size. Without the

auto pact, the major General Motors plant in Ste-Thérèse, Quebec, would be highly vulnerable as would a number of the Ontario facilities of the U.S. Big Three. In the event of a breakup, it is highly probable that the United States would seize the opportunity to terminate the auto pact and to set very stringent terms for any renegotiation. In particular, as noted earlier, the U.S. agenda would include the abolition of the production safeguards under the Canadian portion of the agreement, with serious consequences for the level of assembly operations by the Big Three North American producers in Ontario and Quebec. The highly subsidized Hyundai plant in Quebec would also be in serious jeopardy.

## *North American Free Trade*

Recently, Canada joined with the United States and Mexico in negotiations aimed at establishing a North American free trade area. These talks are intended to build on the existing FTA. They are targeted to be concluded in 1992 — that is, before the proposed referendum on Quebec sovereignty. If these negotiations are successful, a subsequent Quebec separation would raise many of the same issues as for the existing Canada-U.S. FTA. At this point, of course, there is no assurance that the North American Free Trade Agreement (NAFTA) negotiations will succeed.

Beyond the additional complexity, the existence of a NAFTA could have interesting implications for Quebec. Instead of being very much the junior partner within the FTA, Quebec would carry more economic (if not political) weight than Mexico and could be more comfortably included in a quadrangular arrangement. (Assessing the dynamics of such a scenario is beyond the scope of this essay.)

## *GATT Multilateralism*

The issues raised by Quebec separation for trade relations under the GATT are generally subsumed by the bilateral and trilateral issues explored above. Quebec would be obliged to step up to full national

status, with its implications for the GATT codes on procurement, subsidies, and so on. The process would be relatively straightforward and largely painless. The disciplines under the GATT are less onerous than under the various North American arrangements. The benefits are also relatively less important, but significant nevertheless, as the GATT would continue to provide the basic framework for access to overseas markets.

Canada's continuing participation in the GATT would be even more straightforward. It should present no problems, and bring no new benefits.

## Conclusions

Perhaps the most important conclusion to emerge from this analysis is that Quebec's separation would almost certainly require the renegotiation of all the fundamental trade and economic arrangements with its partners. Of greatest importance would be the negotiation of an association with its ROC partners. Like any other trade negotiation between sovereign states, this would be highly complex and difficult to achieve, even under the most amicable circumstances.

The most that could be sought would be to achieve the closest possible approximation to the *status quo ante* — the preservation of the Canadian common market with the minimum possible disruption. There would, however, be difficult negotiating issues to address in fields ranging from agriculture (the dairy program) through to financial services (the status of the Caisses populaires). Quebec would be required to take on the significantly more onerous responsibilities of a national government, losing its historic protection as a subnational government within the Canadian federation. In the charged atmosphere of negotiations between two sovereign countries, it is highly unlikely that such an agreement could be reached.

The much more likely outcome, therefore, is the negotiation of a much less favorable agreement. At best, this would take the form of a customs union. If such an arrangement could be negotiated, it would reduce, but by no means eliminate, the costs. In the more

likely event of some form of free trade arrangement, the costs would be very much more burdensome for both Quebec and ROC, particularly Ontario.

A sovereign Quebec would not be entitled to participate automatically in the Canada-U.S. Free Trade Agreement. It would be required, like Mexico, to negotiate entry. The U.S. agenda undoubtedly would include serious challenges to a number of current policies that Quebec has been able to shelter under the Canadian umbrella, such as industrial subsidies and government procurement. Other important bilateral agreements would also be placed in jeopardy, notably the defense production and development sharing arrangements and the auto pact. The existing arrangements would almost certainly be terminated, and it is by no means assured that satisfactory new arrangements could be concluded.

Failure in either of these levels of negotiation — with ROC and with the United States — would be extremely costly for Quebecers whose living standards depend to a significant extent on the benefits of access to the broader Canadian and U.S. markets. Failure would also be very costly for Canadians who could face the loss of privileged access to the Quebec market and, under some circumstances, the termination of the Free Trade Agreement with the United States. For Ontario residents, in particular, the consequences would be serious indeed.

Given the very high economic costs of failure, there will indeed be a powerful incentive for both partners in the breakup scenario to do their utmost to maintain existing economic relationships. This raises two important caveats. First, if it were easy to agree on free trade arrangements, it would not have taken us 50 years to get tariffs down to present levels. There is no reason to believe the ROC-Quebec negotiations would be an exception to the rule.

Second, the best that could be obtained from these protracted and difficult negotiations is to keep the economic costs to a minimum. Putting Humpty Dumpty back together again would have been child's play by comparison. Even success would mean some significant costs for Quebecers and Canadians alike. Failure could

mean the loss of some significant portion of the benefits that have provided the underpinning for rising living standards over the past half-century.

Undoubtedly, the political decisions to be taken by Canadians and Quebecers over the next few years will turn on the more highly charged issues of national self-determination. The economic issues will be secondary. They will, however, be significant. It would be dishonest in the extreme to assume these issues away by postulating that it will be a simple matter to keep economic matters as they were before through a comprehensive common market arrangement between ROC and Quebec within a continued free trade arrangement with the United States. The more honest assessment is that these arrangements, and whatever benefits they bring, will be placed in the most serious jeopardy.

# Reconstructing North American Free Trade following Quebec's Separation: What Can Be Assumed?

Ronald J. Wonnacott

Suppose Quebec were to declare independence from Canada and then attempt to re-establish free trade ties with "the Rest of Canada" (ROC) and the United States. It is sometimes implicitly assumed that, since it would be in the economic interests of all three parties, some form of free trade arrangement would develop, with the key issue then becoming what form that free trade might take. Would Quebec seek a customs union, a common market, or a free trade agreement (FTA) with ROC, with this union then linked to the United States in the present Canada-U.S. FTA? Alternatively, would Quebec seek FTAs with ROC and the United States, or a trilateral FTA with both?

Although this essay compares some features of these various forms of free trade, its major objective is to examine the assumption that some form of free trade could in fact be negotiated. In some important respects, these alternative free trade formats would have different economic effects. The one specific form sometimes used for illustrative purposes in this study — a Quebec negotiation of two FTAs, one with the United States and one with the ROC — has been selected because it most effectively clarifies the difficulties and conflicts among the three parties that would have to be addressed.[1]

1 Would Quebec necessarily need to negotiate? Could it not, under international law, seek to avoid this by claiming successor rights to the present Canada-U.S...

## Problems in Reconstructing Free Trade in North America

To see why one cannot assume that a North American[2] free trade regime could necessarily be reconstructed that would be in the interests of all three parties, we begin by considering the circumstances most conducive to this outcome.[3]

### *What If Governments Are Rational and Act in the National Interest?*

Even in this case, Quebec might not be able to negotiate free trade with the United States, for several reasons.

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*Note 1 - cont'd.*

...FTA? In fact, Quebec's entry into the Canada-U.S. FTA would, by virtue of the substantial change it would create in that agreement, be contingent on negotiated approval by the United States. Any alternative attempt by Quebec to seek any other form of FTA with the United States would be an even more substantial change, and would also have to be negotiated. In either case, U.S. congressional approval would be required. See Ivan Bernier, "Le maintien de l'accès aux marchés extérieurs: certaines questions juridiques soulevées dans l'hypothèse de la souveraineté du Québec," in Quebec, Commission on the Political and Constitutional Future of Quebec [Bélanger-Campeau Commission], *Éléments d'analyse économique pertinents à la révision du statut politique et constitutionnel du Québec* [Background papers], vol. 1 (Quebec, 1991), pp. 13–14).

2 Strictly to simplify the exposition, "North America" is interpreted here as that part of the continent lying north of the Rio Grande.

3 Although past research on Canada-U.S. free trade implies that all three parties — Quebec, ROC, and the United States — would collectively benefit from free trade, and that both Quebec and ROC would individually benefit, it is possible that the United States could lose. As a large country, it could suffer a terms-of-trade loss from allowing Quebec, as a small country, to trade at the favorable U.S. domestic terms of trade. In other words, it would suffer a loss of tariff income by allowing Quebec to export to the United States duty free. (A similar loss was entailed by the United States in its negotiation of the FTA with Canada, but it viewed this, implicitly or explicitly, as less important than the economies of scale and other benefits it would acquire from increased market size. These benefits would be less im- portant for the United States in an FTA with Quebec, however, because Quebec could provide a market only one-quarter the size of Canada's.) Thus, it might be wrong to assume that all three parties would benefit from free trade. But I set that issue aside to focus on the question of why a free trade system would not necessarily develop even if it were in the interests of all three.

## The United States Might Have Other, Higher Priorities

Even if the United States were to regard free trade with Quebec as beneficial, it might defer negotiations on this issue in favor of talks on issues that it regards as more important, such as trade liberalization at the multilateral or Western Hemispheric levels. Since any negotiation with Quebec would come after the expected date of completion of the Mexican free trade negotiations, Quebec could find itself not as the third prospective partner in the Canada-U.S. FTA, but as the fourth prospective partner in an expanding Canada-Mexico-U.S. FTA, with all the new complications this could imply.

## The United States Might Require an FTA with Quebec to Be Contingent on an Appropriate Quebec-ROC Settlement

While the United States would not wish to get involved in a Canadian domestic dispute or even to appear to do so, there are several reasons why it would be difficult for it to ignore what was happening on its northern border.

First, the United States would have to be a party to putting fractured North American trade relations back together again. In the past, the U.S. administration has found it difficult enough to negotiate FTAs acceptable to Congress; it will not wish to have those agreements reopened and old battles restarted.

Second, the United States would have an economic interest in ensuring that the Quebec-ROC settlement minimizes the damage to the future serviceability of the Canadian debt. That would mean Quebec's undertaking a share of the debt that would reflect its relative ability to service it — for example, a share of about 25 percent, roughly reflecting Quebec's present share of Canadian GDP. If a criterion is used that leaves Quebec with a much lower share[4] and

4 One calculation, partly based on the share of Canadian assets that would go to a sovereign Quebec, suggests an 18.5 percent share of the debt. See Bélanger-Campeau Commission Secretariat, "Analyse pro forma des finances publiques...

therefore leaves ROC with a reduced ability to service its share, then there would be an expected reduction in the value of Canadian government bonds and consequently of other Canadian debt instruments as well. This would exacerbate any fall that might already be occurring because of market uncertainty generated by the breakup of Canada and because of the greater risk associated with a Canadian debt that would be divided among jurisdictions, each of which would have a narrower economic base and hence greater potential exposure to swings in the economic cycle.[5] At the same time, this would imply higher interest rates in Canada, which would have a depressant effect on the economy. The upward pressure on interest rates would continue as long as there were a relatively large debt and the servic-ing problem were therefore to continue. (This would be unlike the current upward pressure on interest rates because of the Bank of Canada's anti-inflation policy — a pressure that should moderate as inflation falls.) Such an increase in interest rates would affect not only Canadians, but also Americans, because U.S. direct investment would become less profitable in a less prosperous Canadian economy,[6] and because Americans would see one of their forms

*Note 4 - cont'd.*

...dans l'hypothèse de la souveraineté du Québec," in Bélanger-Campeau Commission, *Éléments d'analyse économique*, pp. 393–496. The problem is that a debt share based on assets is only one of several possible definitions of fairness. For example, holders of Canadian bonds — whether they be in ROC, Quebec, the United States, or anywhere else — could argue that an alternative definition of fairness, and one that is as philosophically defensible, would be a division of the debt that reflects ability to service it. For these and other methods of dividing the debt, and how each leads to a very different Quebec share, see Paul Boothe and Richard Harris, "Alternative Divisions of Federal Assets and Liabilities" (Paper presented to the conference, "Economic Dimensions of Constitutional Change," sponsored by the John Deutsch Institute for the Study of Economic Policy, Kingston, Ont., June 4–6, 1991).

5 See Matthew W. Barrett, "Renewing Canada: Doing Great Things Together" (Speech by the Chairman and Chief Executive Officer, Bank of Montreal, to the Canadian Club of Montreal, Montreal, May 6, 1991), p. 2.

6 The returns to U.S. direct investment in Canada would also be reduced by the higher interest cost of any borrowing Americans might do in Canada, plus the higher taxes levied by Canadian governments to cover higher interest costs.

of wealth holding — Canadian government bonds and other debt instruments — fall in value.

Third, the United States would not want to see a fragmentation of political jurisdictions north of its border. If the Canadian debt were not divided in a serviceable way, and if separation accordingly came to be viewed as a means by which a province could escape from part of its share of the debt, this would add another incentive for other Canadian provinces to separate. If this increased centrifugal pressure were to lead to a further fragmentation of Canada, the results would be secondary and tertiary rounds of costs, of the form described above, to U.S. holders of Canadian debt.

Thus, a U.S. government with an initial tendency to turn its back on what was happening in Canada would be under pressure not to do so from U.S. financial institutions underwriting or holding Canadian debt — perhaps along with Japanese, Europeans, or other foreign holders of Canadian debt, who might view the United States as the natural conduit through which to express their concerns about separation.

To minimize the perception of interference in Canadian domestic politics, the United States might well do nothing except to respond, when asked, that any FTA with Quebec following separation would have to be negotiated, contingent on an appropriate separation agreement between Quebec and ROC.

If the United States were to take such a position, there is a risk that Quebec's negotiation of free trade with that country could be short-circuited in any number of ways. This could occur if, for example, expectations in Quebec were to become centered on the proposed 18.5 percent share of the federal debt, or a figure close to it. As an analogy, note how conflicting expectations by management and labor sometimes prevent a settlement, even though the resulting strike may be damaging to each party.

Furthermore, even if Quebec were to succeed in negotiating an FTA with the United States, the process of reconstructing free trade north of the Rio Grande would also require free trade between Quebec and ROC. While free trade with the United States would be

crucial to the prospects for Quebec's long-run economic health and, in particular, to its ability to attract foreign investment, free trade with ROC would also be important. Quebec sends roughly a quarter of its manufacturing shipments to ROC, and another quarter to other countries, including the United States.[7]

Even a Quebec-ROC FTA, in conjunction with a Quebec-U.S. FTA, would not be sufficient to restore free trade automatically in North America. One reason is that free trade between ROC and the United States would also be required. Although the present U.S. FTA with Canada presumably would continue to apply to ROC, that cannot be assumed with certainty, since interest groups in the U.S. Congress might view Quebec separation as an opportunity to reopen that agreement. In short, it would not be possible to reconstruct the existing North American free trade regime without agreement among all three parties — Quebec, ROC, and the United States, regardless of the negotiating strategy that may be pursued.[8] (For a discussion of three alternatives, see the Appendix to this essay.)

Since the three parties that would have to agree would include two that were just "divorced", is it reasonable to suppose that decisions would be made solely in the rational light of correctly perceived economic interest that we have so far assumed? Such a rational approach seems unlikely, no matter how much the three parties might be committed to this before the event. But before we address the implications of irrationality, there is an interesting intermediate case.

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7 See Arthur Donner, "Interprovincial Economic Links Getting Weaker," *Toronto Star*, February 18, 1991, pp. C1, C2. Free trade between ROC and Quebec would be required not only to protect their existing trade, but also to prevent the multiplication of U.S.-centered "spoke" bilaterals in a hub-and-spoke system that would inflict permanent costs, especially on all spokes — that is, on all U.S. free trade partners. See Ronald J. Wonnacott, *The Economics of Overlapping Free Trade Areas and the Mexican Challenge* (Toronto; Washington, D.C.: Canadian-American Committee, 1991).

8 One reason three bilaterals would not be sufficient to create full trilateral free trade is that trilateral agreement on some issues — in particular, on rules of origin — would also be required.

## *What If Governments Act Rationally, But Not Necessarily in the National Economic Interest?*

If governments act rationally, does this not imply that they would act in the national economic interest? Not necessarily. They may, for example, have important, overriding political interests; after all, separation itself is driven by political rather than economic motives. But even without such political objectives, governments that rationally respond to voters' expressed economic interests may act against the economic interest of the nation as a whole. The reason is that "the public tends to vote as producers, not as consumers." On many questions — for example, on whether quotas should be imposed on imports of shirts — the effects on producers are large, and they often become single-issue voters. On the other hand, the effects on consumers are more diffuse; while there are many consumers, none is affected very much, and so their votes tend to be influenced by different issues.

Because of this tendency for producers to outvote consumers on any particular issue, legislators who rationally respond to the voting preferences of the public may introduce measures — often protectionist — that benefit producers. There are many examples of such cases where the national interest is not served because producer benefit is more than offset by consumer loss. One notable example was a policy designed to benefit Canadian and U.S. auto producers. The U.S. and Canadian governments pressured the Japanese into imposing "voluntary" restraints on their auto exports. This policy induced the Japanese to keep their cars scarce in North America, and thus allowed them to charge a higher price to Canadian and U.S. consumers. In other words, it induced the Japanese to cartelize their export sales to North America, at the expense of the Canadian and U.S. public.[9]

9 True, this policy provided North American producers with protective relief. However, an offset to this was the higher cost of their autos to North American buyers. While there were additional costs and benefits of this policy, an important net effect remained: it transferred income from North American buyers of Japanese cars to Japanese producers charging a higher price, thus inducing the Japanese to improve their terms of trade at U.S. and Canadian expense.

To confirm that governments often do not act rationally in the national economic interest, consider this question: Why have governments not introduced free trade long ago — even unilaterally, which does not require negotiations — in the many cases in which this would have been in their national economic interests?[10] The reason is not because those in government are stupid or irrational; it is because they respond to voters, and the public tends to vote as producers rather than as consumers. Thus, even though it would be in the economic interests of all three parties to reconstruct their tariff-free North American market if Canada broke up, one simply cannot assume that this could be done at all, let alone quickly. It is far from clear that the complex and painstakingly constructed compromises built into present trade agreements — implicitly in Canada and explicitly between Canada and the United States — could be put back together again. Since these arrangements were negotiated, conditions have changed. In particular, there has been an apparent increase in protectionism in the U.S. Congress because of the prospect of free trade with Mexico, and it is not clear that this will abate as the Mexican negotiations proceed.

## *Finally, What If Government Decisions Are Not Rational?*

In this case, the risks involved in reconstructing free trade in North America would become even greater. No matter how committed both parties to a divorce initially may be to a fair and amicable settlement, perceptions of what is fair will differ when specific decisions have to be made — such as the division of assets and liabilities. Conflicts may be created or exacerbated by lawyers whose job it is to establish and extend the definition of their own clients' fair shares. There may be even fewer grounds for optimism when

10 In theory, there are conditions under which free trade is a welfare-reducing, rather than a welfare-increasing, policy. But these conditions are so special that even those who have identified them typically judge that, on balance, free trade can be expected to increase welfare.

two parts of a country are divorcing. For one thing, each part will have its own set of conflicting internal interests, which means that its negotiating position may change at any time because of a reconfiguration of power among its domestic interest groups. Moreover, there will be a wide range of issues to negotiate, and the greater the number and complexity of issues to be resolved, the more likely that conflicts will arise.

Governments may even be swept along on a tide of emotion that they themselves may have triggered but then find it difficult to control. For example, in an FTA with the United States, Quebec would, as a nation, have to make commitments on financial services and investment that it did not have to make as a province in the Canada-U.S. FTA. If Quebecers came to view these commitments as unacceptable restrictions on their new nation's sovereignty, it might even be difficult to get support for reconstructing North American free trade from Quebec, the country that, by virtue of its size, would need it the most.

While Quebec and ROC might be able to separate without emotions on both sides becoming heavily engaged, the risk is great that it would not occur in this way. To return to our analogy, it is possible that two people who have just been through a divorce proceeding could then, without emotional dislocation, turn around and negotiate an alternative living arrangement with each other; but this is far from guaranteed, no matter how much it may be in the economic interests of each.

## *Concluding Observations on the Broad Problems of Reconstructing Free Trade*

The risks in reconstructing North American free trade following Quebec separation would be reduced if the three parties were to pursue their economic interests rationally. But there is no guarantee of this sort of rationality; and even in this most favorable case, considerable risks would remain.

To draw the discussion together and to illustrate one set of difficulties that would be encountered, consider how the U.S. Congress might view any major alteration of the status quo — whether it be the creation of a trilateral FTA, the negotiation of a bilateral FTA with Quebec along with continuation of the existing Canada-U.S. FTA, or the designation of Quebec as a party to the Canada-U.S. FTA. The required congressional approval would provide an opportunity for various U.S. interest groups to raise concerns about, for example, the environmental effects of the James Bay hydro project. (This pressure might come from those who are genuinely concerned about the environment or from those who, for protectionist reasons, wish to use environmental concerns as an excuse to end or to compromise the North American free trade regime.) In this event, Quebec might face a dilemma: While it would view free trade with the United States as essential for its future development, it might also regard as unacceptable the compromises to its sovereignty necessary to get this free trade.[11]

For Quebec, this problem could be even more serious if it were to find itself not as the third prospective free trade partner with ROC and the United States, but as the fourth prospective partner in a new FTA that includes Mexico along with ROC and the United States. In this particularly unfavorable set of circumstances, Quebec might have to face the same sort of sovereignty issue in a somewhat different form. Suppose that, in their trilateral agreement with Mexico, Canada and the United States require Mexico to meet particular conditions concerning labor laws or the environment. This might then be viewed as a precedent for those three countries to impose on Quebec similar requirements for entry.

11 At the same time, ROC might face a similar dilemma, since U.S. interest groups might raise other concerns in Congress that not only might jeopardize the prospects of free trade between Quebec and the United States, but also lead to a reopening of the Canada-U.S. FTA. One such set of concerns might be Canadian production safeguards and other features of the auto pact. These concerns and the problems they could raise for both Quebec and ROC are addressed in the next section.

But surely, could Quebec not then seek some other trade option? This question goes to the heart of the assumption sometimes implicitly made in the current debate[12] that, for strategic reasons, the United States would not impose unfavorable conditions in negotiating with Quebec because it would not want to force Quebec to look elsewhere for trade partners. But who might these other partners be? Certainly not the European Community (EC) or Japan, the only ones that would be attractive in terms of their technology, wealth, and purchasing power. Were Quebec to pursue free trade or even a more limited preferential arrangement with either of them, it would encounter the same problems as Canada did in its unsuccessful pursuit of a "Third Option" in the 1970s and on several occasions before then. From Canada's point of view, there were several reasons why neither the EC nor Japan was nearly as attractive a trade partner as the United States:

- Higher transport costs (owing to increased distances) would have dissipated gains from trade.
- Japan, in particular, has been interested in Canada's resources, not in its manufactured goods, while the United States has been interested in both. An FTA with either the EC or Japan would have involved probably insurmountable problems in, for example, agriculture.
- Because of existing trade patterns, the costs of trade diversion relative to the gains from trade creation would have been far greater in an FTA with the EC or Japan than in an FTA with the United States.
- Canada could not afford to risk its existing trade relations with its most important partner (the United States) by allowing what the United States would have correctly perceived as the extension of a European or Japanese preferential trade system right into the heart of North America to cover its largest export market. (The hostile U.S. reaction to the extension of the EC's

12 See, for example, Bélanger-Campeau Commission, *Report* (Quebec, 1991), p. 15.

preferential system into the Mediterranean area is a mild preview of how the United States would likely have regarded such a move.)[13]

- Finally, neither the EC nor Japan were interested in pursuing such an option with Canada, because any U.S. reaction would also be directed against them, and would jeopardize their far more important trade with the United States.

These arguments, which made such an option impossible for Canada to pursue, would apply even more strongly to any attempt by Quebec to do the same.

## The Special Problem of Autos

One illustration of why it cannot be assumed that carefully crafted compromises in the present trade agreements would necessarily survive separation is provided by the 1965 Canada-U.S. auto pact, now embedded, in modified form, in Chapter 10 of the 1989 Canada-U.S. FTA.

The auto industry is one of central Canada's most important sectors. Between 1974 and 1989, its share of manufacturing output in Quebec increased from 6.2 percent to 9.3 percent, while its share in Ontario increased from 19.2 percent to 26.5 percent. It is also one of the most sensitive sectors, since there have been several trade conflicts with the United States in this area. The trade regime in autos is now sufficiently complex that the problems of reconstructing free trade in this sector would be substantial. Since the chances of such reconstruction would depend heavily on the position the United States might take, it is important to consider some of the possibilities, beginning with the most damaging, though not necessarily the most likely.

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13 This U.S. reaction was in response to both the extension of the EC's preferential system into the Mediterranean *and* the increase in Mediterranean barriers to U.S. exports. Canada-EC free trade would necessarily involve the former, but need not necessarily involve the latter, depending on the form of the agreement.

## *The End of the Auto Pact?*

Quebec separation would require a U.S. congressional reconsideration of the FTA, and that implies a reconsideration of its auto chapter (the revised auto pact). Would it survive? The answer is that it is much less likely to survive than many other chapters. From the U.S. point of view, the conditions assumed originally in the auto pact and later in Chapter 10 of the FTA would have changed — for example, part of the Canadian market would no longer be available on a preferential basis to U.S. producers. If the auto pact and provisions on autos in the FTA were to be terminated, the present system of safeguards for Canada and duty-free entry of Canadian exports into the United States — subject to a 1965 rule of origin modified in the 1989 FTA — would end. Companies in Canada covered by the auto pact would also lose their multilateral, duty-free sourcing privilege.[14] The future prospects of an industry that has become so important to the prosperity of Ontario and Quebec would be brought into question — especially since plant closures in the industry are already occurring around the world.

It is difficult to assess how likely termination of the auto pact would be. On the one hand, the constituency in the United States that opposes the pact is growing in strength.[15] On the other hand, opposition to such a substantial change in the status quo might be expected to come from the Big Three U.S. auto producers — especially General Motors — which would face the possible reimposition of duties in moving automotive equipment across the border if the pact were to be terminated.

14 Either Quebec or ROC might restore this privilege unilaterally, but then it would become a duty-remission program, and as such it might be subject to countervailing action by the United States.

15 One U.S. concern has centered on the asymmetrical provisions that have safeguarded production in Canada but not in the United States. Another concern has been the use of duty-free access to the U.S. market by Japanese producers located in Canada. Prior to the FTA, this concern was increased by Canadian duty-remission programs to attract the Japanese. Under the FTA, however, these programs were phased out or immediately eliminated.

## *What about an Auto Pact without Quebec?*

If the auto pact were not ended but instead left formally intact between the United States and ROC, then Quebec separation would mean that "Canadian" sales — and, therefore, safeguard levels of production — would fall by about one-quarter. Current levels of production in ROC would then exceed the safeguard levels by an even greater margin than at present. If the safeguards were now effective — that is, if the auto pact companies were now producing near safeguard levels, implying that safeguards were keeping production up — then one could expect production in ROC to fall in line with the reduced safeguards.[16] Since 1981, however, the Big Three have been producing far beyond their safeguard levels. For example, as shown in Table 1, the production of passenger vehicles in Canada in 1990 was about 60 percent above the safeguard level. The excess production of trucks and buses was even greater.

Production in excess of the other operative safeguard — Canadian value added — was a less dramatic but still substantial 20 percent, as it had been for each of the previous two years.[17] Indeed, production in each year since 1982 has exceeded this safeguard by 20–50 percent, except for a 10 percent excess in 1987. This implies that the safeguards have not been binding and that the reason production has been taking place in Canada is because the auto manufacturers judge it to be a good place in which to produce.[18]

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16 Originally, the incentive for auto pact companies in Canada to meet the safeguards was the remission of duty on any imports. As the Canadian tariff on imports from the United States is phased out under the FTA, and no duty will therefore be left to remit on these imports, this incentive will become the remission of duty on imports from third countries — an incentive that has recently been worth $200–300 million per annum.

17 Strictly for simplicity of exposition, the term "safeguard" is used for the Canadian value-added requirement even though it is less binding than the vehicle assembly safeguard, for reasons given in footnote 17.

18 Some production above safeguard levels is to be expected in a world of (i) what economists call "lumpy invested capital" — that is, if a plant is to be built, it must be a large one; (ii) cyclical swings in auto sales that do not necessarily coincide in the two countries; and (iii) no prior knowledge of how a new model produced in Canada will be received in the marketplace. *(Note continues.)*

Insofar as the safeguards have not been keeping production up, one would expect that a reduction in their level would not lead to substantially reduced production.

This could, of course, change in the future, so that an auto pact without Quebec would not be entirely without long-run risk for ROC. At the same time, the risks to Quebec appear to be even greater. What would happen to the GM facility in Ste-Thérèse, Quebec? Could a firm already closing plants in the United States and Canada continue to justify one that would now be in a tariff-ridden location?[19] The answer is not clear; it is even less clear, when sunk costs

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*Note 18 - cont'd.*

This means that prudent companies must plan production somewhat above the safeguard level — although nothing like the 50 percent or 100 percent margin that one now sees in vehicle assembly. It may also be concluded that the 20 percent excess in Canadian value added is well above what is prudently required, because this is a far less binding requirement. Specifically, the companies can run much closer to the Canadian value-added safeguard level because there is no explicit penalty attached to violating it. The reason is that this safeguard did not appear in the auto pact itself, but in letters of commitment by the auto companies to the Canadian government.

The legality of this commitment has never been tested, and it would be difficult and risky for the Canadian government to take action against a company that was unexpectedly in violation one year, if it had been well above this safeguard in previous years and planned to be in succeeding years. For example, Canadian value added of the Big Three and 15 smaller auto pact producers fell 12 percent below the safeguard level in 1980. The Canadian government took no formal action, however, because of the expectation that these producers would increase their investment. That expectation was confirmed; by 1982, these companies were exceeding their Canadian value-added safeguard by 52 percent — indicating that, regardless of the legality of this commitment, they are taking it seriously.

In addition to these vehicle assembly and Canadian value-added safeguards, two other safeguards were also built into the auto pact. But because they were defined in absolute terms, they have long since ceased to be effective.

19 On the face of it, the 2.5 percent U.S. tariff that Quebec exports could face seems of no great concern. However, 2.5 percent of total value translates into a much larger percentage of profit, and this is in an industry that has traditionally been greatly concerned with any potential saving of a few dollars on each car. (Quebec would also face a greater risk of U.S. trade-remedy action if it could no longer resort to the use of the dispute-settlement mechanism contained in the Canada-U.S. FTA. Any such U.S. trade-remedy action could be far more costly to Quebec than the U.S. tariff.) Another problem would be the 9.2 percent Canadian tariff on Quebec's exports to ROC. Finally, there is also the question of what Quebec's new tariff would be, since it would inflate production costs there.

**Table 1:** ***Canadian Production by Auto Pact Companies in Excess of Auto Pact Safeguards, 1975–90***
(percentage)

| | Production of Passenger Vehicles above the Safeguard Requirement | Canadian Value Added above the Safeguard Requirement |
|---|---|---|
| 1975 | 22-28% | 10% |
| 1980 | 6-12 | -12 |
| 1982 | 102-113 | 52 |
| 1983 | 86-108 | 45 |
| 1984 | 75-92 | 38 |
| 1985 | 74-80 | 30 |
| 1986 | 77-86 | 25 |
| 1987 | 62-71 | 10 |
| 1988 | 83-91 | 20 |
| 1989 | 38-45 | 23 |
| 1990 | 58-66 | 20 |

Note: Production is based on 10 major manufacturers.

Source: Canada, Department of Industry, Science and Technology.

are removed from the calculation, what the justification would be for new Quebec plants or the replacement of fully depreciated ones. The real problem would come when existing models are phased out, if not sooner. Would GM make the necessary investment in the Ste-Thérèse facility to retool for new models?[20]

## *What Might Quebec Negotiate?*

Suppose that, to avoid such unfavorable outcomes, Quebec were to seek to negotiate some form of continued status under the auto pact. This would require the agreement of both ROC and the United

20 The other producer in Quebec is South Korea's Hyundai, with a plant in Bromont, southeast of Montreal. This company is not a member of the auto pact, however, and cannot become one, but it still benefits from the Canada-U.S. FTA. If the FTA were to end, this would raise serious concerns about the continued viability of Hyundai's operations in Quebec.

States. Such an agreement with ROC would be far less likely if Quebec were to make a unilateral declaration of separation than if there were an overall separation settlement. As an alternative, why could Quebec not negotiate its own auto pact with the United States? Quebec might find this attractive insofar as it would impose safeguards for Quebec production that would exceed the current level of production there.[21]

It is, however, hard to see how Quebec could possibly negotiate any such auto pact because of U.S. objections. For the United States, the economic-efficiency argument would be far weaker than it was for the auto pact with Canada, because the Quebec market is only one-quarter the size of the Canadian market. Ford and Chrysler could be expected to oppose such an agreement, because it would force them to locate production in Quebec under safeguard restraints — the wrong thrust for companies trying, subject to a minimum of such restraints, to internationalize their production. Restraints of this kind, and the large capital outlays that would be required in Quebec, would be a costly prospect for firms that — in an industry suffering from severe overcapacity — are already having to decide which plants to close next. It is hard to argue that this cost of superfluous investment could be offset by the benefit of being able to continue to move automotive equipment across Quebec's borders duty free.

GM's position is less clear. Separation would make it more likely, though not certain, that the Ste-Thérèse plant would be closed. If that did occur as a result of a Ste-Thérèse plant that would otherwise have been economic being made uneconomic, then there would be a cost to GM. Alternatively, in the face of an auto pact that, following separation, were to cover Canada but not Quebec, it is conceivable that, in its next decision on what should be produced at Ste-Thérèse, GM might even consider turning this plant into a duty-

21 This would be the case even if the safeguards were set at GM's current production level in Quebec — that is, lower than in the present auto pact — because safeguards would also apply to other auto pact producers such as Ford and Chrysler.

free supplier of parts for auto pact companies in Ontario.[22] In fact, in those circumstances, supplying parts to Ontario would be the only way that Quebec output could be exported duty free.[23] While this is not the only way that production might continue in Quebec — and may well be unlikely because of the cost of switching an assembly plant into a parts producer — such parts production to supply Ontario vehicle assembly would be a paradoxical outcome for those who view increased economic independence from ROC as one of the motives for separation. One clear cost of separation to GM would be the loss of its preference over third-country producers in the small Quebec market. Would GM support an auto pact with Quebec to avoid this cost and any costs associated with a possible closure of the Ste-Thérèse plant? The answer is not clear, because it would have the same (albeit less intense) incentive as Ford and Chrysler to avoid location-specific production safeguards.[24]

It follows that there would be far less support in the United States for an auto pact with Quebec than there was for the 1965 auto pact with Canada. At least two of the Big Three U.S. companies that supported the original auto pact could be expected to oppose a new pact for Quebec, and so could the United Automobile Workers (UAW). Indeed, if it had to do it again, it is unlikely that the United

22 Small, independent parts manufacturers in Quebec now selling duty free to auto pact producers in Ontario could continue to do so after separation, provided the U.S.-ROC auto pact continued to exist. Indeed, there would be an incentive for all parts production in Quebec to be channeled into Ontario — where much of it is going already — because auto pact producers in Ontario could get these supplies duty free, whereas producers in the United States could not.

23 Even this trade might be restricted, insofar as parts produced in Quebec would no longer be counted as the Canadian-U.S. content necessary in most Ontario vehicles — namely, those destined for the United States. This would become a much bigger issue if that content requirement were to be increased from 50–60 percent, as recommended by the Automotive Select Panel. While the Canadian government has rejected this recommendation, it is not yet entirely clear what may happen to it in the Canada-Mexico-U.S. free trade negotiations.

24 GM's incentive would be weaker than Ford's or Chrysler's as long as it continued to have the large Ste-Thérèse investment in Quebec.

States would be willing today to negotiate the present auto pact with Canada, let alone a new one with Quebec, for several reasons:

- strong opposition has developed in the UAW to the auto pact's safeguards for production in Canada but not in the United States;
- there is considerable disillusionment in the United States over Canada's insistence that auto pact safeguards be interpreted as permanent; and
- auto companies facing severe overcapacity are opposed to location-specific safeguards.

Even if the U.S. administration were to judge that it could overcome all this opposition, it now has a more pressing agenda of trade liberalization in Latin America.

## *Final Observations on Auto Production and Trade*

With 80 percent of the output of GM's Ste-Thérèse plant going to the United States and 15 percent to ROC, both markets — but particularly that of the United States — are needed to justify production in Quebec. ROC also requires the U.S. market, since most of its output is sold there.[25] While ROC faces risk to its market access from U.S.termination of the auto pact and the FTA, Quebec faces the same risk plus the additional risk that the auto pact would continue, but that Quebec would, through separation, be excluding itself from the pact with no visible prospect of negotiating a replacement agreement.

25 In 1989, 83 percent of Ontario's output of autos was exported. See Thomas J. Courchene, *In Praise of Renewed Federalism*, The Canada Round 2 (Toronto: C.D. Howe Institute, 1991), p. 16.

## Summary Observations on the Broad Issue of Quebec Separation

The message of this essay is simple, for both Quebec and ROC: As long as Canada remains intact, its domestic policies and structure can be changed with little or no risk to the trade agreements that are already in place with the United States. But there would be a grave risk to these agreements if the overall Canadian structure to which these agreements are now linked were to be broken. One cannot assume that agreements that have been so painstakingly developed over such a long period would survive in their present form. In particular, it simply does not follow that they would survive because this would be in the economic interests of the parties concerned.

It would be difficult enough to reconstruct free trade if only two parties — Quebec and ROC — were involved. But the risk of failure would be greater because there would necessarily be three. The United States would also be there, and that means not only the U.S. administration, but also a relatively protectionist Congress — with the risk that implies. Despite its natural reluctance to become involved in a dispute of this kind, the U.S. administration would almost certainly be drawn in, because it necessarily would have to be a partner in the task of reconstructing North American trade.

Moreover, once the U.S. administration recognized that it could not stand aside permanently, it would have a strong incentive to act sooner, rather than later, to reduce the risk of separation and the problems this would raise for the United States. These problems would include not only the difficulties that the United States would have to face in negotiating a new trade regime, but also political and financial concerns. In particular, the United States would not wish to see Canada split into more than one national political jurisdiction on its northern border. On the financial side, the United States would have a strong incentive to ensure that, in the event of Quebec separation, Canada's debt would be serviceably divided. Moreover, there might be an important interaction between these last two concerns. If the Canadian debt were not serviceably divided, and

other provinces accordingly came to view separation as a debt-escape exercise, this could add to the centrifugal pressures on the Canadian federation, and increase the risk to the United States of a further multiplication of political jurisdictions to the north.[26]

Because there would be risks in attempting to reconstruct North American free trade — whether or not the three parties were to act in a rational way in pursuit of their economic interests — those who now propose that Quebec separate unilaterally should examine its prospects if North American free trade cannot be reconstructed, or is substantially delayed. The prospect is disturbing, since Quebec would require free trade with both ROC and the United States to safeguard its present and future trade, and its attraction as a location for foreign investment.

In this downside case, a newly sovereign Quebec would be unable to trade freely with either of its two largest trade partners, which might continue to maintain their own FTA. Quebec, which was the Canadian region most supportive of a free trade agreement with the United States, could paradoxically become the only part of Canada excluded from the agreement. Under such a North American trade regime, the problem for Quebec exporters would not just be their inability to get free access to the U.S. and ROC markets; they would also face discrimination in the U.S. market in competition with ROC, and in the ROC market in competition with the United States. This outcome might be the result of the unpredictable political dynamics resulting from a Quebec-ROC divorce and the actions of a protectionist U.S. Congress, rather than the result of any design by the U.S. administration or the Canadian government. (In fact, it would be costly to those two countries as well.) While this would

26 Despite all these reasons for the United States to resist Quebec separation and the destruction of the status quo, this does not imply that, if separation were to take place, the U.S. administration would necessarily become a willing participant in the partial restoration of the status quo — that is, in the reconstruction of North American free trade. For example, the conflicts that might be created if Quebec were to separate in the face of U.S. concerns might then make any sort of agreement between the two more difficult. Moreover, an earlier point should be re-emphasized: even if the administration were willing to negotiate free trade, it might not be able to do so because of lack of support from Congress.

not be the end of the world for Quebec — especially if, against current odds, there were a substantial move to multilateral free trade in a revived Uruguay Round of talks under the General Agreement on Tariffs and Trade — it would nevertheless have a costly effect on productivity, income, and employment in a relatively isolated Quebec.

There is a message in this for ROC as well. Those who now recommend letting Quebec go should consider the risk of being loaded with a debt that is unserviceable because of the higher interest rate that would have to be paid on it — and possibly because of its increased per capita size — and the risk to ROC's trade with Quebec and the United States. Whether or not there would be free trade between Quebec and ROC, there would almost certainly be more trade restrictions and disputes between them than before separation. The risk to ROC's trade with the United States would depend on the degree to which the Canada-U.S. FTA were to be reopened. True, because of the existing Canada-U.S. FTA, ROC's trade with the United States would be at less risk than would Quebec's, but risk would still be there.

Those in ROC who would let Quebec go often speak with conflicting voices on how ROC should then be designed. Thus, Quebec separation is unlikely to end the seemingly interminable debate on the structure of the Canadian federation; indeed, the debate could even intensify. Moreover, Quebec separation might highlight, rather than reduce, conflicts in ROC, with these conflicts adding to the centrifugal pressures on remaining provinces. Just as separatists should not assume that Quebec's external relations could be kept intact following separation, those who would let Quebec go should not assume that ROC's internal structure could be kept intact.

The reconstruction of North American free trade following a Quebec separation would be neither quick nor easy. Even if reconstruction were ultimately successful, the process would be perceived as involving substantial risks. Accordingly, trade and investment could be damaged in the short run. There could also be costs from the flight of risk-sensitive, short-term capital — costs that would appear, for example, in the form of the higher interest rates that

would have to be paid to reduce this flight. In a world in which Canada's trade partners in Europe and East Asia, and perhaps Latin America, would likely be getting their competitive act together, Quebec and ROC would be struggling to negotiate a return to the status quo — that is, to the present competitive free trade regime in North America.

Moreover, a complete return to that regime would scarcely be possible, because there would be upward pressure on Canadian interest rates. This would be due not only to a temporary flight of risk-sensitive, short-term capital, but also to the permanent risks of investment in separate Canadian jurisdictions, which, because of their narrowed economic base — and possibly because of the increased share of the federal debt that some would have to assume — would have greater problems in servicing that debt. Therefore, capital costs in Canada — and thus the future tax burden from servicing government debt — would be rising at a time when business in Canada would be struggling to control its costs in order to become internationally competitive.

Realism dictates that those people, both inside and outside Quebec, who advocate the breakup of Canada give careful thought to some of the less-favorable outcomes, and to unacknowledged problems involved in the best-case outcomes that are now so often assumed.

# Appendix

## *Other Strategies for Reconstructing North American Free Trade*

A "dual FTA" approach, in which Quebec would seek one FTA with the United States and another with ROC, would be only one of several ways to begin the reconstruction of a North American free trade regime. An alternative would be to extend the Canada-U.S. FTA to include Quebec, possibly with all provisions negotiated in one trilateral deal. Although some technical problems, such as rules of origin, could easily be dealt with in this approach, the broad obstacles to an agreement already described in the text would have to be addressed; they might or might not be easier to deal with in a trilateral negotiation.

In another alternative, Quebec and ROC might form a common market, which would then seek to play Canada's present role in the Canada-U.S. FTA. While this approach would be simpler in some respects — for example, Quebec would not have to seek its own FTA with the United States — it could raise greater difficulties in others. To what extent would negotiations on a common market between the newly divorced partners, Quebec and ROC, be colored by emotions? Would ROC allow some of the provisions of the present Canadian common market to continue to hold? Sensitive issues here include the present high Canadian tariff and nontariff barriers against imports of apparel and clothing, which protect employment in Quebec at the expense of purchasers in ROC, and the quota restrictions on dairy products, which are also heavily concentrated on Quebec. (Quebec's share of dairy quotas is almost double its share of the Canadian population, while its share of employment in clothing and textiles is more than double.)* On the other side of the coin, Quebec might wish to end the protective provisions of the present

* See Murray G. Smith, "The Quebec Sovereignty Scenario: Implications for Canadian Trade Policies" (Paper prepared for the Centre for Trade Policy and Law, Ottawa, 1991, Mimeographed), pp. 5, 6.

Canadian common market that favor Ontario or other provinces at its expense. Thus, it would be no simple task to create a Quebec-ROC common market to simulate the present Canadian one. The more the two differed, the greater would be the potential for a protectionist U.S. Congress to resist allowing this new common market to take over Canada's role in the Canada-U.S. FTA.

A third alternative would be for Quebec and ROC to negotiate a customs union, rather than a common market. A customs union is similar to a common market in that it would provide free trade within the union and common external trade barriers against outsiders, but would not include as broad a set of other "open market" conditions. For example, a customs union might restrict labor mobility, with a resulting reduction in productivity and wages of workers in one jurisdiction who are unable to take jobs in the other.*

There are clearly many other strategies that Quebec might pursue, but regardless of which one it chose, it would face the risks involved in reaching an agreement with ROC — the partner from which it would have just separated — and with the United States, with the resistance from Congress that might be triggered.

* For more detail on the costs of restricting labor mobility, see Richard Harris and Douglas Purvis, *Some Economic Aspects of Political Restructuring* (Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, 1991), pp. 3–4.

# *Agriculture in an Independent Quebec*

W.H. Furtan and R.S. Gray

Quebec independence could have significant implications for the agricultural sector in that province, involving changes that would affect producers, consumers, and taxpayers alike. The eventual configuration of the agricultural sector would be governed by a political process centered on a few key economic issues. In this essay, we identify these issues in an attempt to shed some light on what agriculture in a sovereign Quebec might look like.

Agriculture in Quebec is heavily protected by both federal and provincial laws and institutions. Accordingly, if Quebec were to become independent, any changes in its agricultural policy would evolve from the current system, not from a radically new policy regime. Most agreements between the provinces and the federal government — include those on such issues as supply management, federal transfer payments to the agricultural sector, and federal investments in research stations, farm land, railways, and waterways — would need to be re-examined and possibly renegotiated. Moreover, several federal institutions involved in governing agricultural products could be affected by a Quebec secession and, therefore, could influence a negotiated settlement between a sovereign Quebec and "the Rest of Canada" (ROC).

Agriculture is only a small part of the Quebec economy, producing just 2 percent of the province's GNP, and farmers account for less than 4 percent of Quebec's population. Yet, as in most developed democracies, farmers in Quebec are a well-organized lobby group with the power to have a significant impact on government policy.

**Table 1:** ***Cash Receipts in Quebec's Agriculture Sector, 1990***
(percentage of total, by commodity)

| Commodity | Percentage of Total Cash Receipts |
|---|---|
| Dairy products | 36.84% |
| Pork | 18.79 |
| Poultry and eggs | 13.86 |
| Cattle | 10.52 |
| Corn | 4.79 |
| Vegetables | 4.43 |
| Other crops | 9.77 |
| Other livestock | 0.98 |

Source: Statistics Canada, *Agriculture Economic Statistics*, Cat. no. 21-603 (Ottawa, 1991).

Accordingly, the expected effects of separation on agriculture will influence the sovereignty debate in Quebec.

The cornerstone of Quebec's agriculture is the dairy industry. Table 1 shows that the dairy industry makes up one-third of farm cash receipts in Quebec. Pork and poultry are also important, while field crops — particularly feed grains — are a small but rapidly growing part of the sector. The economic impact of separation on these commodities would directly affect the Quebec's agriculture lobby.

## Federal Support of Agriculture in Quebec

The federal government provides income support to Quebec's agriculture sector in three main ways:

- through expenditure that directly supports agricultural income using a variety of programs;
- through investment in agricultural infrastructure; and
- through supply-management regulations that inflate domestic prices.

**Table 2:** ***Federal Government Agriculture Expenditure, fiscal years 1984/85, 1986/87, and 1988/89***
(current dollars)

| | 1984/85 | | 1986/87 | | 1988/89 | |
|---|---|---|---|---|---|---|
| | Per Capita | Per Farm | Per Capita | Per Farm | Per Capita | Per Farm |
| Newfoundland | 16 | 13,575 | 13 | 11,367 | 22 | 19,874 |
| Prince Edward Island | 256 | 10,840 | 273 | 12,213 | 313 | 14,824 |
| Nova Scotia | 36 | 6,660 | 30 | 6,164 | 39 | 8,570 |
| New Brunswick | 54 | 10,585 | 52 | 10,438 | 86 | 18,329 |
| Quebec | 53 | 7,855 | 40 | 6,324 | 46 | 7,940 |
| Ontario | 32 | 3,682 | 34 | 4,258 | 56 | 7,537 |
| Manitoba | 383 | 13,585 | 480 | 16,806 | 650 | 22,510 |
| Saskatchewan | 733 | 11,287 | 1,255 | 19,985 | 1,270 | 20,764 |
| Alberta | 166 | 7,532 | 257 | 13,854 | 411 | 17,065 |
| British Columbia | 39 | 4,870 | 34 | 5,104 | 38 | 6,000 |
| *Canada* | 129 | 10,598 | 178 | 15,169 | 194 | 16,862 |

Source: Saskatchewan, Department of Agriculture and Food, Regina, 1991.

## *Direct Federal Expenditure*

Direct federal government expenditure on Quebec agriculture amounted to $300 million in fiscal year 1989/90, of which $130 million was a subsidy paid directly to the industrial milk sector in that province.[1] Other federal spending went on such items as cost-shared provincial income-stabilization programs and agricultural research. Table 2 shows federal agricultural transfers to the provinces on a per farm and a per capita basis. Table 3 shows that for every $100 of income from grain and oilseed in Quebec in 1989/90, $27.46 came from transfer payments — which almost certainly represented 100 percent of net income in this sector. As shown in Table 4, Quebec

1 Industrial milk is used to make such products as cheese and yogurt, while fluid milk is used as a beverage. Federal subsidies to the industrial milk sector in Canada were $270 million; Quebec receives nearly half of these because it was assigned the bulk of the country's production quota of industrial milk.

**Table 3:** ***Net Agricultural Benefits by Province and Major Commodity Group, fiscal year 1989/90***
(dollars per $100 adjusted value of production)

| | Red Meats | Grains and Oilseeds | Supply Management I | Supply Management II | Forages | Special Crops | Horticulture |
|---|---|---|---|---|---|---|---|
| Newfoundland | $40.96 | $0.00 | $9.32 | $9.32 | $7.92 | $0.00 | $11.07 |
| Prince Edward Island | 16.48 | 14.67 | 25.01 | 41.66 | 8.24 | 15.32 | 14.86 |
| Nova Scotia | 17.31 | 35.07 | 34.56 | 39.99 | 20.55 | 13.21 | 17.75 |
| New Brunswick | 12.76 | 21.86 | 35.29 | 47.39 | 13.35 | 12.77 | 16.11 |
| Quebec | 14.07 | 27.46 | 32.62 | 57.57 | 9.75 | 8.25 | 24.02 |
| Ontario | 8.65 | 21.14 | 33.91 | 49.63 | 7.60 | 23.10 | 20.11 |
| Manitoba | 4.73 | 34.49 | 32.26 | 44.67 | 6.64 | 25.68 | 23.11 |
| Saskatchewan | 7.97 | 44.08 | 28.41 | 36.58 | 9.75 | 34.96 | 10.99 |
| Alberta | 9.33 | 38.75 | 32.43 | 38.22 | 14.60 | 24.68 | 17.29 |
| British Columbia | 9.17 | 20.32 | 36.08 | 42.63 | 4.91 | 9.60 | 21.27 |
| Canada | 9.42 | 30.79 | 32.98 | 49.24 | 8.89 | 26.10 | 21.96 |

Note: Supply Management I includes dairy benefits based on U.S. external reference prices. Supply Management II includes dairy benefits based on New Zealand external reference prices.

Source: Canada, Department of Agriculture, *Summary of 1989 Net Benefit Report*, vol. 1 (Ottawa, May 1991).

**Table 4:** ***Federal Government Spending on Agricultural Research, Selected Provinces, fiscal years 1984/85 and 1987/88***

| | 1984/85 | | 1987/88 | |
|---|---|---|---|---|
| | Amount ($ millions) | Provincial Share of Canadian Farm Receipts (%) | Amount ($ millions) | Provincial Share of Canadian Farm Receipts (%) |
| Quebec | $31.86 | 14.36% | $26.05 | 15.84% |
| Ontario | 19.46 | 26.48 | 24.75 | 25.70 |
| Manitoba | 11.97 | 9.54 | 12.34 | 9.34 |
| Saskatchewan | 16.59 | 21.37 | 18.78 | 20.09 |
| Alberta | 22.98 | 19.91 | 21.34 | 20.00 |

Note: Does not include research expenditures for institutes.

Source: Canada, Department of Agriculture, Research Branch, *Report 1989–90* (Ottawa, 1991).

has also done well in terms of receiving federal money for agricultural research in past years — better, in fact, than any of the other major agriculture-producing provinces. If Quebec seceded, it would have to give up these large research expenditures.

## *Federal Investment in Agricultural Infrastructure*

The federal government has invested heavily in Quebec's agricultural infrastructure, including such items as transportation facilities, waterways, and farm lands. Some of these investments — on railways and the St. Lawrence Seaway, for example — are shared by nonagricultural sectors of the economy; others — on agricultural research stations — are used exclusively by the agriculture sector.

In terms of spending, the federal government's major research effort in the agricultural sector has been to establish and operate several large research stations. The biggest of these is the central research station in Ottawa, but Quebec has four of them, as well as several smaller substations — including a modern food research

facility at Ste-Hyacinthe. Research stations are allocated approximately in proportion to the importance of agriculture in each region. If Quebec were to secede, it would not substantially affect this balance.[2]

## *Supply Management*

Quebec's agricultural sector derives most of its federal support indirectly through import restrictions and supply-management programs for such commodities as dairy products, poultry, turkey, eggs, and tobacco. These federal restrictions create higher prices for producers.[3] The value of these restrictions to producers is the difference between the border price and the domestic price multiplied by the level of domestic production. Table 5 shows that in 1989 the value of these indirect subsidies to Quebec producers was approximately $569 million,[4] or about twice the total of direct federal expenditures for agriculture. Quebec consumers currently pay most of this subsidy through high food prices. Because of its large provincial quota, however, Quebec exports its surplus dairy products to ROC — with the result that consumers outside Quebec also indirectly subsidize Quebec producers.[5]

If Quebec were to secede, all marketing arrangements between it and ROC would likely be renegotiated. ROC would then have to decide whether to continue some supply-management arrangements with Quebec, to produce its own supply-managed products, or to import them more cheaply from countries such as the United States and New Zealand. Some Quebec farm organizations have already advocated that existing supply-management arrangements

2 See Canada, Department of Agriculture, Research Branch, *Report, 1989–90* (Ottawa, 1991).

3 See J.D. Forbes, R.D. Hughes, and T.K. Warley, *Economic Intervention and Regulation in Canadian Agriculture* (Ottawa: Economic Council of Canada, 1982).

4 One study reports an annual quota benefit of $785 million for all of Canada in 1980. See ibid.

5 Provincial shares of the national production quotas were determined for historical reasons that often do not reflect current comparative advantage.

**Table 5:** ***Indirect Subsidies to Producers of Supply-Managed Commodities, Selected Provinces, 1975–89***
(millions of dollars)

| | Quebec | Ontario | Manitoba | Sask. | Alberta | B.C. |
|---|---|---|---|---|---|---|
| 1975 | 237 | 203 | 23 | 15 | 47 | 55 |
| 1976 | 238 | 196 | 25 | 14 | 47 | 65 |
| 1977 | 184 | 193 | 21 | 15 | 41 | 62 |
| 1978 | 124 | 122 | 13 | 8 | 22 | 49 |
| 1979 | 72 | 132 | 5 | 10 | 23 | 60 |
| 1980 | 176 | 157 | 28 | 17 | 52 | 78 |
| 1981 | 252 | 264 | 40 | 23 | 57 | 96 |
| 1982 | 301 | 310 | 36 | 26 | 66 | 110 |
| 1983 | 187 | 182 | 24 | 22 | 43 | 73 |
| 1984 | 313 | 366 | 37 | 31 | 68 | 96 |
| 1985 | 360 | 375 | 47 | 35 | 79 | 106 |
| 1986 | 333 | 300 | 39 | 33 | 54 | 94 |
| 1987 | 462 | 465 | 58 | 45 | 83 | 124 |
| 1988 | 646 | 647 | 96 | 57 | 130 | 164 |
| 1989 | 569 | 583 | 87 | 56 | 121 | 158 |

Note: Based on U.S. border prices.

Source: Authors' calculations.

remain, arguing that because Quebec now exports agricultural products to other Canadian provinces, this could make farmers in an independent Quebec eligible for a share of what might be interpreted under Article XI of the General Agreement on Tariffs and Trade (GATT) as their "historic market" in ROC.

The implications for Quebec farmers of an end to supply-management arrangements with ROC would be severe. If ROC decided to treat a sovereign Quebec the same as other countries, Quebec's agricultural exports would enter Canada at the world price, not at a supported price. In 1989, for example, Quebec accounted for 37 percent of total Canadian farm receipts for dairy products. If Quebec farmers had to sell their production in ROC at U.S. prices, the losses from the absence of price supports in the dairy industry alone could be as high as $150–200 million annually. If ROC were to increase domestic production to displace current imports

from Quebec, producers in Quebec would then have to find other markets, possibly a difficult task in a fiercely protected industry. Given the prominence of the dairy industry in Quebec's agricultural sector, the negative consequences of an end to supply management here would be considerable — and it would not be confined to farm-level incomes, but would also extend to the province's large milk-processing and distribution complex.

Federal government support for Quebec agriculture now totals about $900 million per year. This includes direct federal expenditures of about $300 million and an indirect supply-management subsidy of $600 million. For the agricultural sector in a sovereign Quebec to maintain its current income, the new country's citizens would have to finance the shortfall between what Quebec taxpayers now contribute and what other Canadian taxpayers contribute — a figure estimated to be approximately $55 million per year. If supply management and current prices were maintained, consumers in an independent Quebec would continue to pay $450 million annually in higher food prices. What is the likelihood that a sovereign Quebec would be willing to provide such support?

## Agricultural Policy in an Independent Quebec

Historically, Quebec has had a strong commitment to its agriculture sector. Indeed, this commitment may go back to the days of the *ancien régime* in New France when, under the seigneurial system, agricultural lands formed the basis of the community. For generations, most French Canadians lived in an agrarian society in which self-sufficiency was often a requirement for survival. The importance of agriculture to French-Canadian society was noted in the 1955 report of the Commission on the Protection of Agricultural Producers and Consumers (the Héon Commission). The Commission's recommendations, which laid the foundation of Quebec's current agricultural policy, reflected the province's strong historic commitment to agriculture — in particular, a strong desire for self-sufficiency; an accep-

tance by producers of direction from government; and a willingness to subsidize a high-cost industry.[6]

Quebec's drive for agricultural self-sufficiency has been very successful over the past two decades. Barley production, for example, increased from 170,000 tonnes in 1980 to 590,000 tonnes in 1990, while corn production increased from 840,000 tonnes to 1.7 million tonnes during the same period, making Quebec nearly self-sufficient in feed-grain production.[7] Milk production per cow increased by 33 percent between 1982 and 1990, as shown in Table 6, while hog production more than doubled between 1970 and 1990.[8] These remarkable production increases were encouraged in part by income-stabilization programs, complemented by a strong agricultural research program. If Quebec were to separate, it would almost certainly want to continue to pursue the goals of self-sufficiency and income support for its agricultural sector.

In evaluating the tax implications of support for Quebec's agriculture sector, one must keep in mind the sector's small size relative to Quebec's population base. Even if Quebec were to pick up the entire $450 million worth of federal subsidies that would be lost on independence — which includes out-of-province supply-management sales — this would only amount to $70 per capita. This cost is far less than the current per capita cost of the federal programs supporting the Canadian agricultural sector. As was shown in Table 2, federal expenditures on agriculture in fiscal year 1988/89 amounted to $184 per capita in Canada on average. One should note that part of the reason for the large federal expenditures outside Quebec is the current miserable state of world grain markets. A similar comparison made during the mid-1970s would show the reverse.

If Quebec were unable to find the fiscal dollars to support its agriculture sector at pre-independence levels, it could adopt the

6 See David W. Sim, *Agriculture in Quebec* (Regina: Saskatchewan Department of Agriculture, 1988).

7 Canada Grains Council, *Statistical Handbook 90* (Winnipeg, 1990).

8 Ibid.

**Table 6:** ***Principal Statistics on the Quebec Dairy Industry, 1982–90***

| | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|---|---|---|
| Number of producers | 19,503 | 19,091 | 18,142 | 17,483 | 17,054 | 16,295 | 15,668 | 14,968 | 14,300 |
| Cattle population (thousands of head) | 712 | 676 | 668 | 628 | 570 | 565 | 560 | 554 | 500 |
| Milk production (average liters per cow) | 4,470 | 4,333 | 4,618 | 4,691 | 5,176 | 5,229 | 5,518 | 5,379 | 5,865 |
| *Production and use* (thousands of hectoliters) | | | | | | | | | |
| Total production | 31,379 | 29,294 | 30,849 | 29,458 | 29,506 | 29,544 | 30,898 | 29,800 | 29,423 |
| Volume sales | 30,129 | 28,094 | 29,699 | 28,322 | 28,401 | 28,444 | 29,838 | 28,770 | 28,438 |
| For fluid purposes | 6,331 | 6,265 | 6,364 | 6,493 | 6,879 | 6,858 | 7,037 | 7,039 | 7,115 |
| For industrial purposes | 23,798 | 21,829 | 23,335 | 21,829 | 21,522 | 21,486 | 22,801 | 21,731 | 21,323 |
| For self-consumption | 1,250 | 1,200 | 1,150 | 1,136 | 1,105 | 1,100 | 1,060 | 1,030 | 985 |

Note: Data for 1989 are estimates; data for 1990 are projections.

Sources: Canada, Statistics Canada, *Livestock Report*, Cat. no. 23-008; Quebec, Bureau de la statistique du Quebec, *Statistiques laitières*; and Quebec, Ministère de l'Agriculture, des Pêcheries et de l'Alimentation, Sous-ministériat des affairs économiques, industrielles et commerciales, February 1990.

European Community model of agricultural support. The grain sector and livestock sectors could be protected by import tariffs, where higher prices are passed on to the livestock sector and eventually to the consumer. The tariff revenue, in turn, could be used to subsidize the export of dairy products. This model of having consumers pay more for food is, in any event, consistent with the philosophy prevalent in Quebec farm organizations, so resistance to such a strategy is unlikely to come from inside Quebec. It is likely, however, to meet stiff opposition from Quebec's trading partners.

## The Effects of a Quebec Secession on Canadian Agricultural Policy and Institutions

If Quebec were to secede, the effects would not be confined to the agriculture sector in that province. An important component of Canadian agriculture — and part of the reason for its success — is the institutions developed to help the industry operate. For example, the Canadian Dairy Commission promotes the production and export of Canadian dairy products, while the Canadian Livestock Feed Board is active in supporting the non-prairie livestock sector and in promoting the use of prairie feed grains in eastern Quebec and the Maritime provinces. How the human capital in these two organizations would be divided if Quebec seceded is not clear. Other organizations, such as the Canadian Wheat Board, the Winnipeg Commodity Exchange, and the Canadian Grain Commission, largely serve western farmers and would not be greatly affected.

Transportation infrastructure is of paramount importance to western Canadian farmers because of their great distance from tidewater and because so much of their production is exported. In the past, the federal government has made large investments in railways, harbors, and waterways. What would happen to these investments, and how would Quebec's leaving affect the transportation of agricultural products, particularly from the prairies and Ontario?

The transportation and grain-handling facilities on the west coast (in Vancouver and Prince Rupert) are large enough to handle two-thirds of all grain exports originating in the prairies. The lower variable cost of moving grain west, directly to salt water, is currently offset by the sunk cost of existing grain-handling facilities in Thunder Bay. As eastern facilities continue to age and the cost of transport through the St. Lawrence Seaway increases, however, it will become more feasible to build larger port facilities on the west coast. Another possibility is to ship through U.S. ports. Currently, all Canadian overseas grain exports go through Canadian ports. This policy, while not always the most economical, aims at developing and sustaining Canadian export capabilities. As the grain trade continues to liberalize under the Canada-U.S. Free Trade Agreement, it will become more feasible to export Canadian grain through U.S. ports on the Gulf of Mexico or in the northwest. With these forces at play, it is likely that the St. Lawrence Seaway will decline in importance as a conduit for Canadian grain, particularly if Quebec seceded.

Quebec's separation would also affect the mix of Canadian agriculture. As a percentage of provincial GDP, the importance of agriculture differs significantly among the provinces, the prairies being more dependent on farming than are Quebec, Ontario, or British Columbia. If Quebec were to secede, the remaining provinces would become even more dependent on agriculture. If the four Western provinces formed a separate union, for example, agriculture would be about 8–10 percent of the new entity's GDP and 10–15 percent of its labor force — large numbers indeed for a supposedly industrialized country.

Regardless of the nature of the political entity that would remain following a Quebec secession, transfer payments would become more burdensome, and the political balance in the farm lobby would change. Currently, there are clear lines between those Canadian farm groups that favor freer trade and those that oppose it. One of the most powerful farm groups in Canada is the Quebec-based Union des producteurs agricoles, which has promoted a protectionist trade policy — particularly with respect to GATT Article

XI of the GATT, on supply management. If this group were removed from the Canadian agricultural policy scene, the remaining groups representing supply-managed industries would continue to lobby for a closed market, but without Quebec their power would be greatly diminished. It is possible that groups favoring freer trade would gain the upper hand in influencing governments.

## Conclusion

A sovereign Quebec would likely continue its strong historical commitment to the agricultural sector, financing any shortfall in support through continued high food prices as well as additional fiscal expenditures. If Quebec decided to leave, the political balance of the farm lobby in ROC could swing in the direction of free trade, thus putting some farm policies — such as supply management — in jeopardy.

# Comments on the Bélanger-Campeau Commission's Papers on Trade Relations

Richard G. Lipsey

In this short essay, I will comment on the Bélanger-Campeau Commission's analysis of the trade-relations problem that a newly independent Quebec would face. The analysis appears in two papers, one by Ivan Bernier and the other by the Commission Secretariat, in a companion volume of background papers to the Commission's main report.[1]

## Trade Relations with the World

### *Entry into the GATT*

In the first paper, Bernier argues — correctly in my view — that the entry of an independent Quebec into the General Agreement on Tariffs and Trade (GATT) would be relatively automatic under GATT Article XXVI. Assuming that Canada would not challenge the sovereignty of a Quebec that had voted to become independent, it is unlikely that serious problems would arise in taking this route.

1 Ivan Bernier, "Le maintien de l'accès aux marchés extérieurs: certaines questions juridiques soulevées dans l'hypothèse de la souveraineté du Québec"; and Secretariat of the Commission on the Political and Constitutional Future of Quebec [Bélanger-Campeau Commission], "L'accès du Québec aux marchés extérieurs et à l'espace économique canadien," both in Bélanger-Campeau Commission, *Éléments d'analyse économique pertinents à la révision du statut politique et constitutionnel du Québec* [Background Papers], vol. 1 (Quebec, 1991).

## *GATT Protection of Quebec's Access to ROC*

Bernier next poses the question: To what extent could a sovereign Quebec rely on the GATT to protect its access to the market of "the Rest of Canada" (ROC)?

### MFN Status

Bernier correctly states that Quebec would, at worst, obtain most-favored-nation status and face the resulting tariffs for goods sold to ROC. This would impose a significant burden — the magnitude of which would depend on the tariff reductions (if any) that might be agreed to when the current, Uruguay Round of GATT talks ends. Post-Tokyo Round, Canadian tariffs average around 10 percent on dutiable items, with a few above 20 percent. However, since many items are duty free, the average tariff level on all items is probably closer to 2 or 3 percent. Still, it would be a significant burden to Quebec business to go from zero to this level of tariffs on sales to ROC. (It would also be a significant burden to ROC firms selling into the Quebec market.) Policing the porous Quebec-ROC borders for smuggling, and checking traffic moving between the two regions, would be a major, costly, and only partly effective undertaking.

### Supply-Managed Products

Although Bernier seems to suggest that Quebec's position with respect to dairy product and poultry marketing boards might be protected under the GATT by reference to the situation that existed prior to Quebec independence, this seems unlikely to me. The precedent for arguing that such protection exists is murky, and ROC could be expected to resist strongly the acceptance of such a prece-

dent on the grounds that ROC consumers should not subsidize producers in a province that had decided to secede.

## Nontariff Barriers

Bernier expresses no great concern regarding nontariff measures such as countervailing and antidumping duties that relate respectively to subsidies and to predatory pricing. This lack of concern seems to me to be unrealistically sanguine. An independent Quebec and ROC, trading together under normal conditions, would find many cases in which countervailing and antidumping duties were feasible. Antidumping duties are currently in common use, and Canada has applied them to U.S. imports in many cases.

The situation surrounding subsidies is more complex. Canadian firms have shown restraint in bringing countervailing duty cases against U.S. producers, even when good grounds have existed. The reason they usually give for their restraint is that, because the United States would find ways of retaliating, it is better to accept the slap in the face of U.S. countervailing duties than to risk the punch to the stomach of alternative retaliatory measures. No such restraint would operate between ROC and an independent Quebec, which would be less unequal in size and power than the United States and Canada. Both governments undertake substantial subsidization now.

As a result, there would likely be a rash of countervail cases based on the current subsidy practices of ROC and Quebec, and a level of antidumping action no less than now occurs on Canada-U.S. trade. Both would take place with or without the extension of the current Canada-U.S. Free Trade Agreement (FTA) to include Quebec, because such trade-remedy measures are not precluded by that agreement.[2] No doubt such developments would cause significant disruption to existing trade between the two regions.

2 The magnitude of the potential disruption would depend on the fate of the proposed new GATT subsidies code, the fate of which, in turn, is intimately linked with the outcome of the whole Uruguay Round.

## *Extending the Canada-U.S. FTA to Cover Quebec*

Bernier correctly argues that Quebec cannot expect to gain automatic entrance to the bilateral FTA. Quebec's entrance would have to be renegotiated. If this were done, gaining GATT approval for the extended FTA should pose no problems.

## U.S. Reactions

Bernier next asks: How would the United States react? His response is that the United States would not want to let the economic and political benefits of its FTA with its northern neighbor(s) be eroded, and that it would, therefore, be likely to negotiate Quebec's accession on roughly the same terms as the present bilateral FTA.

The common habit of personifying a country's decisionmaking process is particularly hazardous when it comes to the United States. It is not too unreasonable to regard Canada, the United Kingdom, or any country with a British parliamentary type of government, as a single, decisionmaking individual. However, the checks and balances purposely written into the U.S. Constitution mean that the United States cannot reasonably be so regarded. Bernier's argument may well apply to the U.S. administration, but there are no strong reasons to think it would apply to the legislative branch, which is open to many, and varied, political pressures. In the past, the majority voting to extend the fast track to give the administration authority to negotiate trade-liberalizing treaties has been precarious. Negotiations with Canada only made it by courtesy of a tie-breaking vote by the Chairman of the Senate Finance Committee, and to get permission to negotiate with Mexico, the administration had to agree to challenge the decision of a bilateral panel in such a way as to jeopardize the whole future of the Canada-U.S. FTA.

The text of the FTA was the result of a carefully crafted set of compromises, and it is not surprising that politicians and the public — insofar as they are aware of such tradeoffs — are upset about the

concessions made by their side, while accepting those of the other side as being entirely reasonable and natural. There will be a strong temptation in the current trilateral negotiations with Mexico to reopen such matters as Canadian support of its cultural industries and the surveillance of foreign takeovers of Canadian-based firms whose size exceeds $150 million. There is some concern that Canada may have to walk away from the negotiations should the United States demand concessions on these issues, no matter how great is the Canadian interest in staying inside any evolving hemispheric free trade movement. (The reason would be that no Canadian government, facing an early election, could give up the protection of the cultural industries negotiated in the original, bilateral FTA.) If the pressure for such concessions is strong in the Canada-U.S.-Mexico negotiations, it would be much stronger in the case of new trilateral negotiations covering the United States, ROC, and Quebec.

An important added consideration is that many Quebec government policies that were exempt from the terms of the bilateral FTA, by virtue of Quebec's status as a province, would be covered by the FTA once Quebec became a sovereign nation. The United States would be unhappy with the whole interventionist thrust of Quebec industrial policy, and a raft of issues, such as the behavior of the Caisse de dépôt et placement du Québec and the use of cheap, subsidized electricity as an instrument of industrial development, would come under severe pressure. There would be a major battle between Quebec and U.S. views on basic socio-economic policy, and only rash observers would predict the outcome.

## ROC Reactions

It is clear from these brief considerations that the whole carefully crafted set of compromises embodied in the present FTA could fall apart. This seems much more possible when it is understood that the ROC government in charge of new negotiations may not be Conservative. If the Liberals or the NDP were doing the negotiating, their hostility to the current FTA might further increase the chance of the

negotiations foundering. Not only might Quebec fail to gain admission, but ROC might lose its own FTA. Although much of the public has been persuaded that this would be no great loss, financial markets and foreign investors would have no doubt of the seriousness of that eventuality. ROC's and Quebec's standing as a home for foreign direct investment, and their ability to export to the United States, would be dealt a serious blow. By the same token, domestic firms hoping to serve the North American market would find ROC and Quebec less attractive locations relative to the United States (and Mexico).

### A Risky Venture

No one can tell what the chances are of such an unfavorable unraveling. But they cannot be dismissed as negligible. Given an increased representation of Democrats in the U.S. Congress, along with some further setbacks that encourage U.S. protectionist sentiments, and given a government in Ottawa that fails to appreciate the importance of the FTA, the possibility certainly exists that ROC and Quebec would lose their FTA.

## Economic Relations with the Rest of Canada

### *Attitudes in ROC*

One key point in assessing the reactions of ROC to an independent Quebec would depend on what party was running the government at the time that separation arrangements were negotiated. Were the Reform Party in power, there might be a different reaction than if the Liberals or the NDP were in power. A party that felt no obligation to an independent Quebec might not behave in quite the accommodating way that the Bélanger-Campeau Report assumes. Furthermore, although statespersons would see the mutual benefit of an amicable

separation, public hostility in ROC might demand that the former province be punished in some way.[3]

## *A Full Economic Union Is Unlikely*

The key issue is the kind of economic relations that would be enshrined in a treaty between the two former partners. A full economic union would allow for relations in terms of mobility of people, goods, investment, and right of establishment (important in services) much as they are now.

It seems unlikely, however, that this would be the case, and the first casualty might be the free movement of people. ROC's hostility to Quebec's separation might result in moves to subject Quebecers to the same immigration controls that now apply to the citizens of other countries. Canadians who refused to grant special status to Quebec when it was one of the provinces may be unwilling to give it special status when it is one of the world's sovereign nations. The many francophones who have moved to ROC in the past presumably would have regarded restrictions on such movements as undesirable.

A second casualty would probably be the current monetary union of equal partners. Quebec might well choose to use the Canadian dollar as its legal tender, but it might not be in ROC's interest to take Quebec in as a partner in setting monetary policy. Indeed, I would recommend that ROC say to Quebec that it can adopt the Canadian dollar if it wishes, but that it should not expect to have any say in ROC monetary policy. It is doubtful how long Quebec would wish to use the Canadian dollar under those circumstances.

Investment screening would provide some interesting issues. In pursuit of its "Quebec Inc." policy, Quebec might like to extend investment screening to ROC firms wishing to make direct investments in Quebec. ROC might feel the same about Quebec firms

3 Both Ron Wonnacott and Gordon Ritchie deal with this point in more detail in their contributions to this volume. Both warn that the political process often produces results that would not have been recommended by any rational person surveying the available choices.

investing in its territory. Such restrictions on capital movements would be unfortunate, although their importance would depend on how rigorously the right to interfere with the free flow of investment was actually pursued.

## *A Common Market Is Essential, But Not Assured*

Even if a full economic union proved impossible, a common market, with its unified restrictions on trade in goods and services with the rest of the world, would seem to be a necessity, as the Bélanger-Campeau Commission's Secretariat argues. An FTA that allows each country to have different trade restrictions with the rest of the world would require customs points on trade between Quebec and ROC and rules of origin to determine when a good was, or was not, made within the FTA. As already mentioned, this would be a highly unfortunate development. But could the two countries agree on common external barriers and on all the other common policies entailed by a common market? Presumably, Quebec would merely accept the existing Canadian ones in the first instance. But the common market would require that in all subsequent negotiations with third countries, including subsequent GATT rounds, ROC and Quebec would speak with a single voice. Reaching agreement on a common external policy might not be as easy as some, who have never tried, might think.[4]

Gordon Ritchie takes it as axiomatic that a customs union must be preserved on grounds of mutual self-interest:

> The issue may be captured by a look down Highway 401 at the Quebec-Ontario border on a weekday afternoon. Any impediment to that ceaseless flow of traffic would be very costly — while a customs union would significantly slow the flow of

4 Gordon Ritchie considers these issues in some detail. His discussion shows how hard it will be to create and maintain the required common policies under the pressures of very different socio-economic policies in Quebec and ROC.

activity, depending on the extent of border formalities required, a free trade arrangement would bring the traffic to a standstill.

Canadian trade policy analyst Murray Smith is more pessimistic than Ritchie on the possibility of preserving the present customs union:

> [M]aintaining a customs union requires some minimal degree of political union, because of the divergence in regional interests. Conversely, the rupture of the Canadian political union seems to almost inevitably imply the dismantling of the Canadian Customs Union. What is difficult to anticipate with precision is whether the Canadian Customs Union could be dismantled without leading to any significant impairment of the internal economic union within Canada. Even at a technical level this seems impossible. For example, if Quebec and the rest of Canada had any separate external commercial policies then there would need to be internal trade restrictions to police the external non-tariff barriers of either part of Canada, just as the European community continues to maintain internal non-tariff trade restrictions under Article 115 of the Treaty of Rome in order to implement the residual non-tariff trade restrictions of member states of the European Community. Indeed, one of the central elements of Europe's 1992 agenda is to remove these remaining internal non-tariff barriers and to consolidate the common market. It seems ironic that Canada, with a much smaller internal market than the European Community, could be headed in the opposite direction.[5]

## Other Trade Issues

### Existing Trade Restrictions

Reaching agreement on particular restrictions that benefit producers by harming consumers would be difficult, as other writers in this

5 Murray G. Smith, "The Quebec Sovereignty Scenario: Implications for Canadian Trade Policies" (Paper presented to the conference, "Economic Dimensions of Constitutional Change," sponsored by the John Deutsch Institute for the Study of Economic Policy, Kingston, Ont., June 4–6, 1991, Mimeographed), pp. 7–8.

volume suggest. The Bélanger-Campeau Commission Report suggests that the GATT might come to the rescue by forcing Canadian policy with respect to restrictions on dairy and poultry products and on textiles to become less onerous in the future. But there seems little current prospect for this happy outcome. If the status quo continues, Quebec may have some serious problems. A ROC government, with no obligations to Quebec, could be expected to be reluctant to have ROC consumers continue to subsidize Quebec producers. In this case, a policy that allows Quebec dairy producers to sell in ROC at artificially inflated prices, and Quebec textile manufacturers to do the same, would be seriously questioned. Were I making plans from within Quebec, I would not rate it as more than 50/50 that the present protection of Quebec textile manufacturers under the Multi-Fibre Arrangement, or of Quebec farmers under provincial marketing schemes, would be continued in their present forms.

## Tax and Regulatory Policy

Finally, the Secretariat favors Quebec's adoption of the current federal legislation in areas such as banking, competition policy, patents, bankruptcy, and transport, as well as harmonization in areas such as corporation tax and pension plans. This is all very civilized and if both countries are lucky, it is what will happen at first. Over time, however, separate national interests have a way of interfering with cooperation that is in mutual self-interest. Political capital can often be gained by blaming other countries for one's own problems, and pressures to favor one's own producers and consumers build up.

It cannot be assumed that, over time, rationality will always prevail. How much interference to the desirable, cooperative behavior on each of the dimensions just identified will occur over time cannot be predicted. But that some — enough to do significant damage — will occur seems a likely prediction based on observing how most other governments have behaved most of the time.

## Omitted Issues

Some important trade related issues are not considered in the two Bélanger-Campeau Commission background papers. I will illustrate by mentioning just one important item: the conduct of Canadian trade diplomacy. Rather than give my own opinions, I will quote at length from an analysis of these issues presented by Murray Smith:

> One of the economic gains from the present federation in Canada, which is often overlooked, is the conduct of trade diplomacy. Whether it is dealing with trade disputes under the present Canada-U.S. FTA or under the GATT, or dealing with international negotiation, the economic size and viability of the Canadian Customs Union influences Canada's international economic leverage....It is evident in the GATT that an economy such as Canada has rather more bargaining leverage for the settlement of a trade dispute, than does a small economy [such as] Nicaragua, which had a trade dispute with the United States under the GATT....
>
> [W]hether one is considering the process of completing the Uruguay Round of GATT negotiations or coping with the fallout if the Uruguay Round fails, whether one is negotiating new trade rules with the United States under Chapter 19 of the Canada-U.S. FTA, [or] negotiating with Mexico and the United States the parameters of a trilateral FTA, or dealing with Europe after the completion of the 1992 agenda, or responding to Pacific or Latin American initiatives, a united Canada will have more clout — however modest that may be — than a fragmented entity or entities in advancing the economic interests and in securing the livelihood of Canadians....
>
> [I]t is evident that [Canadian] influence would decline as a result of a rupture in the Canadian federation. Canada would no longer be a member of the G-7 or the Quadrilateral Trade Ministers (representing the European Community, Japan and the United States as well as Canada). The rest of Canada would be a diminished middle power like Australia and Quebec would be comparable in population to Austria.[6]

6 Ibid., pp. 11–12.

It is hard to gauge the consequences of this diminished clout in trade diplomacy. But in the harsh world of growing "systems frictions"[7] and pressures to manage trade or to impose solutions on unwilling trade partners (using such tools as voluntary export restraints), this diminished clout should not be treated lightly. As with so many other issues, we just do not know the quantitative effect of this crucial factor.

The number of issues raised here, any one of which could have serious consequences, must be a cause for concern. Those politicians who say to the public, "the political separation of Quebec from the rest of Canada is a low-risk operation with few potential downside consequences," are guilty of seriously misinterpreting a complex and highly uncertain situation.

7 Systems friction is economist Sylvia Ostry's term for the modern development in which domestically oriented policies have international effects and become the concern of trade policy negotiators.

# Constitutional Political Economy and Trade Policies between Quebec and Canada

Rodrigue Tremblay

## The Foundations of the Current Constitutional Crisis

Canada's present constitutional and political crisis stems from the adoption of the *Constitutional Act of 1982* without the consent of the government of Quebec or the approval of Quebecers through a popular referendum, coupled with the collapse of the Meech Lake Accord in 1990 and public hostility to the agreement in English Canada. This crisis has little to do with the federal government's economic or trade policies *per se*. However, the massive and crucial support Quebec gave the Canada-U.S. Free Trade Agreement (FTA) in 1988, while English Canada's attitude toward it was generally opposed, may have contributed to the negative climate against Quebec and the French fact in segments of the English-speaking Canadian electorate.

The actual constitutional and political aspects of the crisis fall, rather, in the realm of constitutional political economy and public choice, since they evolve from the adoption of a constitutional contract. Indeed, since representative government is organized according to majoritarian principles, constitutional guarantees are crucial to national minorities — such as French-speaking Quebecers in a multinational political system. Thus, one can ask whether a constitution can legitimately be adopted without the explicit approval o

the largest national minority or whether a national majority can impose its constitutional will on a national minority.

This is the fundamental majority-minority problem of the Canadian federation, as it is in other federations of the same nature, such as the Soviet Union or Yugoslavia. Although the national minorities question can be suppressed for awhile when such artificial federations function under totalitarian rules, sooner or later it can undermine the very existence of a political federation. Because Canada is a democracy, the constitutional crisis is less acute here than in these other federations or political empires, but the underlying cause of constitutional and political frictions is the same: How can a national minority survive and prosper under a system of majority rule, when no constitutional contract between the majority and the minority has been legitimately ratified?

In the months ahead, Quebec will face a fundamental dilemma: whether to remain a Canadian province under a Constitution that the Quebec Assemblée nationale has solemnly rejected and that still needs to be "reformed", or to move toward home rule as a distinct country within a looser confederation with English Canada. A Quebec law (Bill 150) has already established that a constitutional referendum will be held on the constitutional future of Quebec no later than the fall of 1992.

It is most unlikely that the Constitution can be amended before then, because its existing amending articles require either the unanimity of all governments (article 41) or the support of seven provinces and 50 percent of the Canadian population, with or without Quebec (article 38). Accordingly, the 1992 Quebec referendum will resemble the one held in 1980 in the sense that arguments to persuade Quebec to remain a Canadian province (one out of ten and possibly one out of 12, if the territories are given provincial status) will likely be based on constitutional proposals and promises, on the one hand, and on predictions of dire economic consequences and of economic reprisals if it chooses to declare its independence, on the other. Because of time and political constraints, therefore, effort may be devoted less to solving the problem and more to buttressing the federalist versus the *indépendentiste* case.

Earlier this year, the Bélanger-Campeau Commission outlined the major political options for Quebec and published various economic studies on Quebec's future.[1] Since then, the federal government has set many civil servants to work to develop the answers and counter-arguments that federalist politicians will need as ammunition during the next referendum campaign.

The C.D. Howe Institute's decision to publish a series of studies on the constitutional crisis and on the consequences of Quebec's leaving the Canadian federation is a commendable attempt to address key issues and to provide useful information and insight toward either solving the crisis or preparing a harmonious transition to a new political order. Nevertheless, it is easy to lose sight of the fundamental questions when analyzing various political or constitutional scenarios, or attempting to identify the effects of particular economic or trade policies: As the only political entity in North America in which French-speaking people form a majority, what should Quebec's political status be? Can the Canadian political system accommodate this reality? It is because of questions such as these that the answers to the constitutional crisis cannot be found in any particular economic or trade policy.

## North American Free Trade

All the other essays in this book examine the politics of trade policies. They imply, first, that political considerations are important in framing trade policies and, second, that English Canada would likely turn protectionist if Quebec were to secede, even though Quebec itself is oriented toward free trade — specifically toward North American free trade.

This is a legitimate concern. Given the greater appeal of protectionism in English Canada, Quebec's absence from the Canadian federation might tip the political scales away from trade liberaliza-

1 See, for example, Quebec, Commission on the Political and Constitutional Future of Quebec, *Eléments d'analyse économique pertinents à la révision du statut politique et constitutionnel du Québec* [Background papers], vol. 1 (Quebec, 1991).

tion and encourage those who would denounce the FTA. The same protectionist appeal could even lead to misguided attempts to disentangle the intertwined input-output tables of the Maritime provinces, Ontario, and Quebec that trade flows in goods and services have woven over the years. Indeed, without Quebec's massive support of the FTA during the 1988 federal election campaign, the outcome could easily have been a repeat of the 1911 election, when the Canadian electorate rejected a similar agreement.[2]

Does English Canada need Quebec, then, if the political support for trade liberalization is to be maintained? My feeling is that, even though the FTA was not and is not popular in English Canada, it is now a *fait accompli*, and no future Canadian government will be able to turn back the clock. North American free trade is here to stay; moreover, it will grow, because it is the wave of the future. The business of the FTA is not finished, however. Rather, it is the beginning of a process of continuous negotiations, not unlike the evolution the European Community (EC) has gone through since 1958. The question of domestic subsidies and countervailing duties is far from settled, for example, and so are many other issues such as agricultural trade, trade in cultural products, the regulation of business services, and policies on the automobile industry. Future Canadian federal governments, with or without Quebec, would surely want to change the breadth of trade and industrial issues that should be treated on a North American basis. Sections of the FTA could actually be renegotiated. In other words, future Canadian governments could accelerate or slow the process of North American trade and economic integration, but they are unlikely to be able to stop it or to reverse it.

In the unlikely event that English Canada were to withdraw from the FTA, this would be considered a major blow to the goal of

2 The November 21, 1988, election, was was largely fought on the free trade issue with the United States, gave the Progressive Conservative Party 169 seats — a majority of 43 seats over the Liberals' 83 and the New Democrats' 43. The Conservatives' majority was entirely owing to voters in Quebec, however, where they won 63 seats to just 12 for the Liberals.

the current U.S. administration to establish free trade not only in North America — by including Mexico — but also in all the Americas. By withdrawing from the FTA, English Canada would isolate itself economically from its most important trading partner.

Would English Canada keep a sovereign Quebec from joining a North American Free Trade Agreement? Could it do so? Besides the irony of the less-free-trade-oriented political entity using free trade as a political lever, this is also most unlikely, for two reasons.

First, such a move, besides being childish and petty, would run up against present U.S. trade policy. For the U.S. government, free trade and geopolitical stability go together, and it would not want to see Quebec excluded from a North American agreement. Indeed, at US$27.5 billion, Quebec's two-way trade with the United States is 40 percent as much as Mexico's US$68.6 billion.[3] It would be most illogical, therefore, to work toward extending the FTA to Mexico, then roll it back with Quebec.

Second, the geopolitical aspect of trade policy is always an important consideration for the United States. Indeed, the push for free trade with Mexico is aimed at the 1994 Mexican elections and at preventing Mexico from falling under a socialist regime with close ties to Castro's Cuba. What U.S. interests — or Canadian interests, for that matter — would be served by destabilizing Quebec, with the St. Lawrence valley so strategic for the defense of the continent? Why would the United States want to promote a Cuba of the North?

One therefore has to clearly distinguish between the situations prevailing *before* and *after* a change of political status by Quebec. There is no doubt that, before the event — and especially during a referendum campaign — the federal government will be able to

3 In 1990, Quebec's exports to the United States amounted to US$15.9 billions, while U.S. exports to Quebec were US$11.6 billion, or about 3 percent of total U.S. exports. In the same year, Mexico's total exports to the United States (including those from the Maquiladoras) were US$30.2 billion, and U.S. exports to Mexico totaled US$28.4 billion, or about 7.2 percent of U.S. exports. See Quebec, Bureau de la Statistique du Québec, *Commerce international du Québec, 1991 Edition*; idem, *Statistiques*, June 1991; and "The Mexico Pact: Worth the Price?" *Business Week*, May 27, 1991.

persuade some U.S. politicians to make negative statements about Quebec's future role in the FTA. But once Quebec's political status is democratically clarified, the extension of the FTA to Quebec would follow the rules of international law — namely, that such treaties continue to apply to the formerly covered territory until expressly modified.

This all presupposes that Quebec and Canada do not maintain an economic union or a common market. In the latter case, as in the EC, a common trade policy would prevail and the composition of the FTA would not change.

## North American Free Trade and the Auto Pact

Ron Wonnacott raises the interesting question of whether the revised auto pact, outlined in Chapter 10 of the FTA, would survive if Quebec's political independence were to require U.S. congressional reconsideration of the FTA. Indeed, one of the primary reasons the Canadian government decided to ask the U.S. government to negotiate an overall free trade agreement was the fear that the 1965 auto pact would have to be renegotiated in isolation. Since about a quarter of Ontario's manufacturing sector was and remains dependent on the automobile industry, largely due to the success of the auto pact, Canada rightly believed it was much more prudent to reopen the pact within the overall trade negotiations than on a purely industry or sectoral basis.

Chapter 10 of the FTA is not closed; a select committee has been established to study the future development of the automobile industry in North America, and Mexico's arrival in a trilateral agreement will affect the industry considerably. Nevertheless, the FTA was successful in saving the principal features of the original auto pact — the production safeguards.

During the 1988 federal election campaign, people in Ontario did not understand — or were not made adequately aware of — why the FTA was so important for the future prosperity of the automobile

industry in their province and, to a lesser extent, in Quebec. It would now be most foolish for the Canadian and Quebec governments, after a democratic move by Quebec toward political independence, to behave in such a manner as to require a reopening of the FTA. Such a move would jeopardize a large and strategic part of Ontario's industrial structure and would also hurt Quebec's economy.

Moreover, even if the revised auto pact were not renegotiated, the breaking up of domestic Canadian sales between "the Rest of Canada" (ROC) and Quebec would also make the production safeguards less binding and therefore less favorable toward Ontario, since that province accounts for more than 90 percent of total Canadian automobile production.

It would therefore be in the fundamental industrial interests of both ROC and Quebec that a *common market relationship* continue to operate, whatever form political and constitutional changes might take. This approach would not only be "simpler," as both Ron Wonnacott and Gordon Ritchie allude to, but it would also be the most sensible and practical. Doomsday scenarios can be intellectually appealing, but economic realities would undoubtedly exert their basic influences in framing real governmental choices.

The common market relationship would keep actual interprovincial trade flows going, and it would make the reopening of the FTA unnecessary. The capacity to service the huge public debt that both Canada and Quebec have accumulated over the years requires strong economic structures. Dislocating their industrial economies and jeopardizing their external trade flows are not the ways to remain solvent and meet this debt-service challenge. In these matters, the federal and Quebec governments will have to compromise and face the daily realities of economic life and economic inter- dependence.

## Economic Relations between a Sovereign Quebec and ROC

If the FTA is here to stay and likely to expand — with Quebec's continued participation — what would, or should, be the nature of

economic relations as a whole between a sovereign Quebec and ROC? Here again, it is necessary to distinguish statements and actions before and after secession. It could indeed be good tactics for some politicians and opinion leaders in English Canada to engage in some posturing to influence the issue for an eventual sovereignty referendum in Quebec, as they did during the 1980 referendum campaign. Threatened political empires always resort to tactics of intimidation to preserve their hegemony; the only difference is that some go further than others. There is little, however, that a political economist can say about such tactics. Statements such as "you know, we will not be rational" cannot be assessed with the analytical tools that economists normally use.

The actual economic integration of Quebec and ROC is not a project, but a reality that has taken two centuries to build. The input-output structures of the economies of the Maritime provinces, Quebec, Ontario, and, to a lesser extent, Western Canada are tightly interwoven. Such an economic integration rests largely on free trade in goods and services, the mobility of capital and labor, an interregional banking system, integrated capital and money markets, and a single currency.

Nobody of influence in Quebec is talking the 19th-century language of establishing customs points and independent currencies. The 21st-century fact of North American economic integration is widely accepted, and parochial politicians who would attempt to stir emotions against economic integration with ROC would have little success.

Just as it is on North American free trade, the ball representing post-secession economic relations between Quebec and ROC is in ROC's court. No government of a sovereign Quebec would establish customs barriers between Quebec and the Maritime provinces, or between Quebec and Ontario. Would a ROC government act in a contrary way against a sovereign Quebec? Would it propose that the rules of origin be applied for goods traded between Quebec, Ontario, and the Maritime provinces? Would it propose that Canadian and Quebec companies lose their right of establishment and their na-

tional treatment status? Would it propose that competition laws be replaced by countervailing and antidumping rules? Would it propose that labor mobility be curtailed? All these would happen if the current common market were dismantled. Would the ROC government elect to dismantle the interregional banking system and the integrated Canadian and Quebec money and capital markets? It would, if the present monetary union were to be split into two currency areas.

Yet, since Toronto — and Ontario, in general — is the hub of interregional corporate, commercial, financial, and banking activities, east and west of the Ottawa River, such a dismantling of the common market and monetary union would clearly be a case of shooting oneself in the foot! If the common market and monetary union were continued, the principal beneficiaries would not only be ordinary Canadians and Quebecers, but also all those connected to Canadian manufacturing firms (such as Northern Telecom), to large distribution firms (such as Canadian Tire), to large financial firms (such as Sun Life Insurance), and to large banks (such as the Royal Bank of Canada).

In general, the only possible net losers from a political rearrangement between Quebec and ROC would be professional politicians and bureaucrats in Ottawa, since a smaller central government or a more decentralized Canadian political system would reduce their importance. This is why "end-of-the-world" scenarios can be expected to originate from these quarters.

On the specific question of economic cooperation, it is far from certain that even people operating in the Ottawa region would benefit from a dismantling of the present common market and monetary union. Some lament that, without Quebec, Canada would no longer be a member of the Group of Seven or of the Quadrilateral Trade Ministers group, or other clubs of major economic powers. This would not necessarily be so, however, if the Canadian common market were maintained. Britain, for example, used to be a member of the inner circle of countries of the General Agreement on Tariffs and Trade, but it is now represented in the Quadrilateral Trade

Ministers group by the EC. If this was acceptable to Britain, why should the Canadian political establishment regard such a development as unthinkable?

## Specific Industrial and Trade Issues

Trade policy must be considered a whole, since many industries are affected directly and indirectly by tariffs, quotas, taxes, and subsidies. Interregional trade flows reflect these public interventions, but they are also influenced by capital flows, currency values, and discrete changes in policy such as the FTA, the auto pact, or the late National Energy Program.

In 1984, Quebec bought $31.9 billion of goods and services from ROC and sold $30.8 billion of goods and services to ROC, in a clearly two-way relationship of considerable magnitude.[4] It is often suggested, nevertheless, that Canadian consumers subsidize Quebec's textile and clothing industries because of their relatively high external tariffs and quotas. (These industries are also well represented in Ontario.) They have been declining, however, in Quebec as in other Canadian regions over the past 25 years because of trade liberalization and increased competition from Third World countries. Indeed, during the 1980–90 period, employment losses in Quebec through plant closures in the textile, shoe, and clothing industries accounted for about 50 percent of total job losses in the province.[5]

Because the FTA has increased competition for these industries, because the federal government has expressed its willingness to renegotiate the Multi-Fibre Arrangement, and because Mexico is likely to join the FTA, it is to be expected that such "protected" industries are becoming *de facto* less and less protected and that their relative importance will continue to decline. The subsidization of

4 See, for example, Statistics Canada, Input-Output Division, *Compilation spéciale des flux du commerce interprovincial pour 1984* (Ottawa, 1990).

5 See *Les Affaires*, Cahier spécial, June 15, 1991, pp. 6–7.

these industries could have been an issue 20 years ago, but it is unlikely to be an issue in 2000.

As it is in the EC, agricultural policy in Canada is largely based on production quotas and price subsidization. The pressures arising from the FTA to lower the input prices for "transformation" industries will undoubtedly increase in the future, and Canadian agricultural policy is bound to be re-examined. Which agricultural product is most heavily subsidized? This is a complex issue; the estimates in Table 1 indicate that it is difficult to single out one agricultural product and elect not to subsidize it. Here again, a total and comprehensive approach may be best. Gordon Ritchie's suggestion that both Quebec and ROC should elect to "leave everything just as it is" for awhile may be the wisest course of action, and it is one to which I would subscribe. Adjustments at the margin could be preferable to unplanned transformations done in a helter-skelter way.

## Conclusion

Things must be kept in perspective. In a free and democratic society, constitutional and political changes in political structures, when decided by the people, are not welfare diminishing; it is when constitutions and political structures do not reflect the wishes of the people that they are welfare diminishing.

As Richard Lipsey has said, "We must not fall into mutual recrimination....We must not risk an acrimonious breakup. We must begin to think about how to do it in a civilized manner."[6] If it is the democratic wish of the people, political structures can and should change. One hopes that professional economists can contribute to rational thinking and discourse by providing analyses that throw some light on the problem and on its possible solutions.

If Quebec were to become sovereign, after a democratically expressed free choice, this would not be the end of the world. There

6 Richard G. Lipsey, "Some Economic Aspects of the Failure of the Canadian Federalist Dream" (President's 25th Anniversary Lecture Series, Fletcher Challenge Theatre, December 13, 1990).

**Table 1:** ***Agricultural Production Subsidization in Canada, 1988***
(as a percentage of producer income)

| Commodity | Percentage of Producer Income |
|---|---|
| Wheat | 46% |
| Other grains | 41 |
| Soybeans | 18 |
| Sugar | 25 |
| Vegetables | 38 |
| Milk | 74 |
| Beef and veal | 46 |
| Pork | 14 |
| Chicken & turkey | 32 |
| Eggs | 34 |
| Cattle | 47 |
| *Total* | 43 |

Source: Organisation for Economic Co-operation and Development, *Agricultural Policies, Markets and Trade* (Paris, 1989).

would be technical difficulties, but the only place where there are no problems to be solved is a cemetery. Since 1958, the EC has shown the world that no problem is insurmountable given leadership and enlightenment.

Institutions can indeed be adapted to the requirements of our time — the need to give people direct control over their political institutions and the need for large economic units built on the principles of economic freedom. Canada, in area the second-largest political system on earth — and, as such, a genuine political empire — can either resist these changes or it can move democratically toward implementing them. My hope is that the second attitude will prevail.

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